



SIGMA Papers No. 4

Management Control
in Modern Government
Administration: Some
Comparative Practices

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**MANAGEMENT CONTROL IN MODERN GOVERNMENT ADMINISTRATION: SOME
COMPARATIVE PRACTICES**

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

This publication is intended as a reference tool for officials in government administrations and supreme audit institutions (SAIs) of central and east European countries (CEECs) who are concerned with building cost-effective structures of controls appropriate to their democratic market economies.

The publication is also intended to support seminars on the subject of Management Control which the SIGMA Programme will continue to offer to national administrations and SAIs on request.

The subject of this volume, Management Control, focuses on a concept and a set of practices which have become recognised in recent decades as one of the foundations of effective management in organisations in both the public and private sectors. As management modernisation proceeds in the public sector in CEECs, the top managers of line ministries, finance ministries and SAIs are seeking to build an "architecture" of control systems and control institutions which will achieve satisfactory results without being too costly, and which will also advance the democratic/market transition process. SIGMA believes that the ideas embraced in the term Management Control will be a useful contribution to the dialogue among these three groups.

Contrasting with the traditions in most CEECs, most OECD Member countries place the primary responsibility for control on the shoulders of the line management while the SAI plays a strong role as "promoter" of strengthened management control and validator, through the audit studies, of the controls in place. The papers in this publication display the widely different approaches taken in OECD Member countries to implement management control, and demonstrate the many weaknesses and mistakes to which, like other management functions, it is subject. Yet they also illustrate the underlying validity of the concept especially in a period when governments everywhere are trying to decentralize operations as much as possible.

These papers are intended to provide real-life examples of the principles set out in Guidelines for Internal Control Standards, published by the International Organisation of Supreme Audit Institutions (INTOSAI). SIGMA is grateful to INTOSAI for their permission to reprint the Guidelines as the Annex to this publication for ease of reference. All papers in the book are cross-referenced to the numbered paragraphs of the Guidelines using the following format (I, para. xxx).

SIGMA wishes to thank the distinguished authors of these papers who are identified in the chapters which follow. We wish also to thank Mr. Janusz Wojciechowski President of the Supreme Chamber of Control of Poland who has supported this project by lending the services of experts from his office to help in the selection of topics and the vetting of draft papers from authors.

Mr. Richard Allen, recently of HM Treasury (UK), served as project manager, taking over this task when Mr. Graeme Kirby, the initiator, returned to Canada. We wish to thank both for their co-ordination efforts as well as for the fine papers they have contributed. Converting papers, even very good ones, to a publication is a complex task; it could not have been achieved in this case without the contributions of Ms. Doranne Lecercle as English editor, ARCHITEXTE as French translator, Ms. Marie-Laure Onnee as French editor and Ms. Nathalie Lukasiewicz, Ms. Joan Levins and Ms. Alison Millot of the SIGMA Secretariat.

Neither SIGMA nor the authors intend anything in this book to be taken as a "model". Rather it is hoped that the ideas developed and the stories of successes and failures will help our colleagues in CEEC to analyse their own control needs and to design systems and approaches which will be appropriate to their traditions and aspirations.

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MANAGEMENT CONTROL IN MODERN GOVERNMENT ADMINISTRATION AN INTRODUCTION

by

Richard I.G. Allen¹

Executive Summary

Management controls are a set of practices that have become recognised as one of the essential features of effective management in organisations of all sizes, in both the public and the private sectors, throughout the world.

The papers included in this volume cover the same subject matter as the *Guidelines for Internal Control Standards*, published in June 1992 by the International Organisation of Supreme Audit Institutions (INTOSAI). These guidelines propose four general standards and six detailed standards on which to base effective management control systems.

Management controls may be briefly defined as the organisation, policies, and procedures used to help ensure that government programmes achieve their intended results; that the resources used to deliver these programmes are consistent with the stated aims and objectives of the organisations concerned; that programmes are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported, and used for decision making.

This publication focuses on the control mechanisms and procedures that need to be built into an organisation's systems in order to provide reasonable assurance that top management's objectives will be met, rather than on the design and application of management information systems, which, we believe, are generally well understood in Central and Eastern European countries (CEECs). The studies included give examples of management controls in widely different areas of the public sector -- such as road construction, overseas aid, and social welfare -- and in countries with differing constitutional and cultural backgrounds, political and legislative structures, and public service traditions. They examine the importance of management controls to the manager and auditor and discuss the role played by different government institutions -- including the finance or budget ministry, the supreme audit institution (SAI), and other central institutions -- in developing and implementing management control systems.

Effective management controls are clearly essential to the success and well-being of government organisations, both as a safeguard against waste, abuse, and fraud and as a means of ensuring that the policies laid down by top management are properly implemented by the organisation. However, even the most carefully designed control systems have their limitations, partly because, while they allow top managers to control the organisation, they do not control the top managers themselves. Continuing vigilance is required to ensure that the systems are not undermined by instances of fraud or by failure to respond to changes in circumstances and operating procedures.

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Building effective management control procedures is difficult in any organisation. The more complex the system of government and the inter-relationships with other parts of the economy, the more extensive and complicated are the management controls required. Moreover, the papers included here underline the key point that, although all of the countries reviewed apply most of the INTOSAI standards explicitly or implicitly, they do so in very different ways, depending on their constitutional and cultural characteristics. No single model of management controls can be applied to all countries, nor is there a unique pattern for how such control systems are likely to evolve over time. This is likely to be as true for the CEECs as it is for the countries reviewed here.

Areas in which differences among the countries reviewed appear to be particularly marked include the definition and role of internal audit; the extent of centralisation or decentralisation of management controls; the extent to which controls are promulgated through primary legislation, regulations backed by legislation, or administrative procedures; the extent to which management controls form an integral part of an organisation's management and decision-making structure or are carried out by independent units outside the direct management line; and the constitutional status and role of SAIs and the extent to which they operate independently of government.

1. Introduction

This volume focuses on a concept and set of practices which have become recognised in recent decades as one of the foundation stones of effective management in organisations both large and small.

Good management control systems are essential to a well-run organisation. They permit top managers to have confidence that the procedures and processes necessary to the sound management of the organisation's resources -- financial, personnel, IT equipment, accommodation, capital equipment, and so on -- are in place and effective and, if they are not, to take corrective action. Top management can then concentrate on the issues for which they should be responsible -- business strategy and the planning and implementation of operations.

The terminology used varies from one country or one organisation to another. The papers on management control systems and procedures included here cover the same subject matter as the INTOSAI *Guidelines for Internal Control Standards*, which propose a number of fundamental principles and standards on which to base effective management control systems. These Guidelines (reprinted as Annex I) refer to this body of disciplines as "internal controls" rather than "management controls". Whatever the term, the principles and practices described are likely to be used, in one form or another, in public and private sector organisations throughout the world. They may sometimes be described as integrated controls built into the management systems and processes. In other cases, they may be described as self-regulating or automated processes. Outside the developed economies, however, they may not be conceptualised and codified as an integrated management function. This publication is designed to help achieve that goal.

Over the past 25 years, the concept of "management control" has become integral to the science and practice of management in OECD Member countries, although it is subject to as many disputes and difficulties, conceptual and practical, as other management functions.

A traditional business school definition says that the functions of the manager are to "plan, organise, control, direct, and motivate". Chapter II of the INTOSAI Guidelines (I, para. 9) elaborates on the third of these:

Management controls ... are the framework of the organisation -- all the plans, policies, procedures and practices needed for employees to achieve the entity's objectives.

The INTOSAI Guidelines define a set of standards for designing and auditing management controls. The papers included here aim, instead, to give examples of such controls, to show their importance to the manager and the auditor, and to discuss the roles played by different government institutions in defining and implementing management control systems.

The remainder of this introductory paper discusses important differences in the definition and usage of certain concepts relating to management controls (e.g. internal audit); the concept and scope of management controls; limitations of management control systems in practice; the main features of the INTOSAI Guidelines; related European Union guidelines; the relationship between management controls and the so-called "new public management"; techniques for auditing management controls and evaluating their effectiveness; and the contrasting practices and experience of different countries, drawing on the information and analysis included in the following papers. A brief conclusion follows.

Differences of definition: internal audit

A careful reading of the papers in this volume reveals certain differences in the definitions and usage of key concepts. This is particularly true of the definition of internal audit. A EUROSAI Experts Meeting held in September 1994 on "The Supreme Audit Institution and its Relation to Internal Audit" concluded that:

There is no INTOSAI standard defining internal audit. Nor is there a definition of internal audit contained within international standards.

In the United Kingdom, for example, internal audit is defined by the UK Institute of Internal Auditors as "an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation". The British National Audit Office's approach and standards relating to the internal audit of government departments and agencies mirror those of the private sector.

In the United States, the US Institute of Internal Auditors uses a definition of internal audit similar to that of the United Kingdom, namely:

... an independent appraisal activity established within an organisation as a service to the organisation. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.

However, Havens notes, in his contribution to this volume, that "the complex structure and diverse functions of the United States government have led to internal auditing practices that are different in many ways from those in the private sector". His paper discusses extensively the causes and effects of these differences.

While in most countries, internal audit is part of an organisation's management control system, this is not so in Germany, as Sparberg points out in his study:

In ... Germany, the internal audit is part of the external audit. Although the internal audit forms an integral part of the activities of the administrative agencies, the internal auditors are only subject to the professional and technical guidance of the FCA [the German supreme audit institution]. They only report to the FCA and may not take any other professional orders. Therefore, the internal audit in Germany is called a "pre-audit", not in the sense of an *a priori* audit, but because they carry out their audits before the FCA.

Citing further examples of differences in definition and approach, the report of the EUROSAI Experts Meeting notes that, in France and Italy, "internal audit is seen to embrace aspects of internal control, such as public accountants and inspectors in France who perform key functions in the control of expenditure" while in countries such as Poland "internal audit is seen to embrace certain [state] regulatory and supervisory bodies; in addition to controls over public expenditure these bodies are responsible for controls over technical standards and safety issues. Elsewhere, for example in Romania, internal audit extends to control bodies operating within commercial companies, [reflecting] the power of the Supreme Audit Institution ... to report on those bodies in addition to ... State institutions".

2. Concept and scope of management controls

Management controls may be briefly defined as the organisation, policies and procedures used to help ensure that government programmes achieve their intended results; that the resources used to deliver these programmes are consistent with the stated aims and objectives of the responsible organisations; that

programmes and resources are protected from waste, fraud, and mismanagement; and that reliable and timely information is obtained, maintained, reported, and used for decision making.

It is important that management controls should be viewed, not as separate systems in their own right, but as control mechanisms to be integrated into the systems serving the entire cycle of planning, budgeting, management, accounting, and auditing. The systems should support the effectiveness and integrity of every stage of this cycle and provide continued feedback to managers.

As McCrindell points out in his contribution to this volume, one of the main objectives and strengths of an effective management control system should be to enhance the ability of managers to manage, to release their management potential, and to act as a positive force for achieving the aims and objectives of the organisation. Such controls help to make individual managers accountable but should not be regarded as a constraint on their freedom to take decisions in areas for which they have delegated authority.

Management controls guarantee neither the effectiveness of government programmes nor the absence of waste, fraud, or mismanagement. However, they are a means of managing the risks associated with government programmes and operations. Controls should be appropriate and cost-effective and backed up by proper analysis and assessment of risk. Sophisticated risk management techniques have been developed to provide professional support to government ministries and agencies in these areas.

Management controls can be viewed as having two aspects:

- the management information systems required by management to steer the work of the organisation, to monitor the progress and quality of operations, and to evaluate the results and performance of the organisation;
- the policies, systems, procedures, authority delegations, etc., that are built into the organisation's processes to provide reasonable assurance that management's objectives are being achieved.

We believe that the first of these themes is generally well understood in the CEECs, and the focus in this volume is therefore on the second, namely, control mechanisms and procedures, rather than management information systems.

In his discussion, Kirby describes the relationship between the two aspects as follows:

The management of operations requires information obtained both from within and from outside of the organisation. Some of this information concerns the use of resources, and some concerns matters such as the delivery of goods and services or changes in the needs of "clients". Management information is an integral part of management control, but not all controls require the provision of information in order to be effective.

Effective management control systems in most organisations start from the expectation that individual managers are responsible and accountable for the quality and timeliness of the operations and programmes they manage, for controlling the cost of the resources they use, and for ensuring that their operations and programmes are managed with integrity and in compliance with legal requirements and with the regulations and guidelines promulgated by the central agencies (such as Prime Minister's office or Cabinet office, finance or budget ministry, and the supreme audit institution).

Chapter I of the INTOSAI Guidelines (I, para. 1) makes a similar point:

Internal control is a management tool used to provide reasonable assurance that management's objectives are being achieved. Therefore, responsibility for the adequacy and effectiveness of the internal control structure rests with management. The head of each governmental organisation must ensure that a proper internal control structure is instituted, reviewed, and updated to keep it effective.

An important part of such a structure should be an effective "early warning" system to help ensure that all managers, both at the top of the organisation and in line positions, are given timely and accurate information when failures occur, and that they are held to account through an appropriate system of controls and, where necessary, through the imposition of sanctions and penalties. Safeguard procedures of this kind are essential in all organisations, both in the public and private sectors, because, when system failures occur, they can be costly and destructive.

Another essential requirement of well-designed management control systems is that they should provide top management with credible, timely information, including financial data, on key aspects of performance. An important implication of this, stressed by Kirby, is that management control systems should be developed in an iterative manner starting from the top of the organisation:

The current and likely future needs of the most senior executives must be identified, an understanding of the means of gathering the necessary information must be developed, and that process, as well as those required for other control systems, must be integrated and provided to the most senior managers for their use. Finally, a process must be established for turning senior management's decisions into action.

3. Limitations of management control systems in practice

Effective management control systems are clearly essential to government organisations, both as a safeguard against waste, abuse and fraud, and as a means of ensuring that the policies laid down by management are properly implemented by the organisation. As Havens points out, however, continuing vigilance is required, because changing circumstances and operating procedures can render ineffective even the most carefully designed control system.

There are other limitations to the effectiveness of management controls. Havens cites the example of the U.S. Medicare programme. Because of its size and complexity -- with tens of millions of transactions each year -- it has proved impossible to develop cost-effective management controls and auditing procedures that reliably prevent or detect abuse. Military defence procurement and contracting systems are similarly difficult to control. Moreover, Havens points out that even well-designed management controls serve their purpose only if personnel comply with the requirements of the control system and management responds to reports of alleged deficiencies. It is easy for controls to lead to a false sense of security. This is true in both the public and private sectors. In the widely publicised recent case of the Singapore branch of Barings Bank, for example, it appears that supervisors took no corrective action in the face of reports that one of the bank's traders was operating beyond the limits set by the bank. In a relatively short period of time, the enormous losses incurred by the trader -- running to several hundred millions of pounds sterling -- resulted in the bank's insolvency.

Havens points to a further potential weakness of management control systems. Such systems are intended to give reasonable assurance to top managers that all levels of the organisation are following management's policies and safeguarding the financial interests of the organisation. But although they allow

top managers to control the organisation, they do not control the top managers themselves. Management controls can be bypassed or defeated with relative ease by top managers who are inclined to do so. The private sector has seen many instances in which top managers have misappropriated large sums of the company's assets. In some cases, this has only been brought to light when the company was declared insolvent. There are well-documented cases in the public sector as well. Havens describes the example of the "HUD scandal" in the United States, exposed in the late 1980s, where corruption in the Department of Housing and Urban Development (HUD) reached the highest levels of management:

It became common knowledge in certain circles that the Secretary [of HUD], working with or under the influence of his Executive Assistant, was prepared to allocate programme funds as political favours. Investors wishing to have a project approved by HUD learned that the way to succeed was to hire as a "consultant" an individual whose political connections gave him access to the Secretary or his Executive Assistant. At the consultant's request, the Secretary or his Executive Assistant either approved the project or instructed other HUD officials to do so.

The three case studies in this volume describe similar examples of the vulnerability of management control systems from Danish, Dutch, and German experience with agricultural, social welfare, and road building programmes, respectively. In the German study, for example, Sparberg shows the importance of developing strong management controls to deal with a number of problems in the road construction area, where effective control has proved difficult to achieve in practice:

- price fixing, where bidders for a government contract decide among themselves who is to submit the lowest tender and at which (higher) prices the others will submit their bids;
- flaws in contract procurement procedures where, for example, after expiry of the tendering period but before contract awarding, bidders may try to change their bid to their own advantage;
- collusion, where the responsible civil servant within the contract awarding department or agency and the bidder secretly co-operate to secure for the company a competitive advantage in the award procedure.

Similarly, Lashmar's study of the United Kingdom gives some recent examples of areas where management control systems have been found to be inadequate, resulting in heavy losses to the national budget. These include the Ministry of Defence's works programme, customs and import controls designed to regulate cross-border shopping, and employment termination payments made by the Department of Health. For Canada, Kirby gives two examples of federal agencies -- the Canadian International Development Agency and the National Capital Commission -- where fresh management was brought in to tackle serious problems of fraud and inefficiency by implementing new management control systems.

4. INTOSAI principles and standards

The INTOSAI Guidelines (I, para. 4 and paras. 18-62) lays down four general standards and six detailed standards as a framework which countries are recommended to use in designing and developing their systems of management control.

The general standards proposed by INTOSAI are as follows:

- **Management control structures are to provide reasonable assurance that the general objectives will be accomplished.**

["Reasonable assurance" means that the cost of management controls should not exceed the benefits derived.]

- **Managers and employees are to maintain and demonstrate a positive and supportive attitude toward management controls at all times.**

[This points to the fact that the commitment of the most senior managers to setting the appropriate "tone at the top" is crucial to achieving this objective.]

- **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 organisational objectives.**

[To develop specific control objectives, INTOSAI recommends that organisations group operations into those that are "regularly recurring" and then categorise these groupings into management activities, programme (or operational) activities, financial activities (budgets, flow of funds, assets and liabilities, and other financial information), and administrative activities (support functions such as library services, mail processing and delivery, printing, and procurement).]

- **Managers are to continually monitor their operations and take prompt, responsive action on all findings of irregular, uneconomical, inefficient, and ineffective operations.**

[Monitoring includes addressing issues raised by audit findings and recommendations reported by internal and external auditors in order to determine what corrective actions are needed.]

The detailed standards are as follows:

- **The [management] control structure and all transactions and significant events are to be clearly documented, and the documentation is to be readily available for examination.**
- **Transactions and significant events are to be promptly recorded and properly classified.**
- **Transactions and significant events are to be authorized and executed only by persons acting within the scope of their authority.**
- **Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions and events should be separated among individuals.**
- **Competent supervision is to be provided to ensure that [management] control objectives are achieved.**
- **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 INTOSAI Guidelines (I, paras. 5-6) note that these standards would be:

... applicable to all governmental organizational units. They can be viewed as the minimum acceptable standards that organizations follow when instituting internal controls and provide criteria for auditors when auditing the internal control structure. The standards presented here are not new ideas. Many of them are currently incorporated in government operations. Their presentation as a framework, however, may be new.

Since 1992, the Chairmanship of the Internal Controls Committee of INTOSAI has passed from the General Accounting Office of the United States to the supreme audit institution of Hungary. This Committee has continued to develop the ideas set out in the Guidelines, which have been translated into several languages. A world-wide bibliography of management control systems has been prepared. The INTOSAI Congress, which was held in Cairo in September 1995, agreed further plans for the work of the Internal Controls Committee. This will include, over the next three years, the issuing of detailed guidance on the implementation of control standards.

5. Application of INTOSAI standards in the European Union

The supreme audit institutions of the countries of the European Union (EU) issued, in September 1993, a set of implementing guidelines for use in audits of European activities. These guidelines are somewhat narrower in scope and definition than those in the INTOSAI Guidelines, so as to be of greater operational value to the organisations that use them. They define internal or management control as all the instruments, procedures, methods, and systems put in place by an organisation to ensure that it achieves adherence to externally and internally imposed rules and requirements (laws, regulations, management directives, etc.); that it safeguards resources so as to promote economical, efficient and effective operations; and that it presents reliable financial and management information.

The European guidelines focus particularly on the administration of the EU's Common Agricultural Policy. This is an area which has given rise to severe problems of lack of control and to cases of massive fraud which have been researched and documented by bodies such as the European Court of Auditors. Indeed, the European Union guidelines include a supplement concerning standards for auditing irregularities caused by fraud. It is important to develop an effective network of management controls to deal with transactions based on EU programmes or budgetary disbursements; these need to be applied both at the Community level and at national level. But this is not easy to achieve in practice, as is shown by Elm-Larsen in the Danish case study.

6. Relationship between management controls and the "new public management"

The public sector reforms frequently referred to as the "new public management" (NPM) emphasize performance (the "three Es" of economy, efficiency, and effectiveness) rather than compliance with prescribed processes and regulations. There is a strong emphasis on:

- turning the focus of management away from the use and control of human resources, capital, and other inputs and towards the identification and measurement of the outputs of the organisation;
- letting managers manage by lessening controls over them and giving them greater responsibility for taking decisions for the programmes and resources they manage;

- in return for this increased flexibility, there is greater accountability through mechanisms such as performance contracting and reporting.

Inherent in this approach are two components. First, there is some trade-off between complying with defined rules and procedures, and taking measures to enhance an organisation's performance. For example, reducing the procedures prescribed for approvals for government capital investment projects may increase the risks of impropriety but, on the other hand, is likely to reduce the costs. Risk management involves developing arrangements for managing these risks, although it cannot eliminate them. Second, internal control mechanisms and external oversight or audit bodies should change the emphasis of their investigations from "rowing" to "steering" the organisations concerned.

Some countries, particularly those with an "Anglo-Saxon" tradition of government, have taken the application of NPM principles further than others. In such countries, management control procedures and systems may require modification to adapt to the NPM (see, for example, the papers on Canada and the United Kingdom).

The essential message in all this is that effective management control is essential whether management systems are centralised or decentralised. Control systems will need to be adapted as organisations decentralise their management structures. As decentralisation takes place, it is the job of the newly empowered manager to take his share of responsibility for making the control systems effective. The Preface to the INTOSAI Guidelines notes that:

... the interest in [management] controls has grown as government management has become more complex. This complexity does not allow management to review the correctness of every individual employee task. Many governments are looking for ways to provide more economical, efficient, and effective services and to control deficits and debt. This often involves reorganizing old structures, revising old procedures, allowing managers more freedom, and increasing reliance on automated technologies. In such an environment, an effective [management] control structure can provide reasonable assurance that management's objectives are being achieved.

7. Techniques for auditing, monitoring, and evaluating management control systems

Countries use widely differing techniques and approaches for auditing management control systems and monitoring and evaluating their effectiveness. In some countries, the legislative requirements are detailed and prescriptive. For example, in the United States, heads of government agencies are required to produce an annual report and evaluation of the organisation's management control systems. Other countries have more informal, less rule-based arrangements. Some have highly decentralised systems in which heads of government organisations are given considerable freedom to design their own management control systems, but the external auditing body (or bodies) and/or parliament have substantial scrutiny powers.

No "standardised" set of techniques for auditing management controls can be recommended. Practices differ from country to country. Most management control systems include a mixture of:

- pre-audit controls in which, for example, transactions need to be authorised not only by the relevant supervisor or manager but also countersigned by a more senior official;
- concurrent audit controls in which, for example, budget estimates or the delivery of services according to a specified time schedule are verified;

- post-audit controls in which the outcome and effectiveness of a set of actions, expenditures, or policies are monitored and evaluated.

There is also an important distinction to be made between internal audit and external audit, even though, for reasons explained above, this distinction is sometimes blurred (as in Germany), partly because there is no internationally agreed definition of internal audit. In many countries, the reliance that can be placed on the management control systems of a ministry or government agency is fundamental in deciding which audit approach the external auditor will take. Where a government organisation can demonstrate that it has effective internal audit arrangements in place, together with rigorous, well-established management controls, an external auditor may decide to rely on the management control system, thus obviating the need for extensive and detailed external audit.

In assessing the effectiveness of an organisation's management controls, the external auditor will typically apply a number of tests. These are helpfully described below by Lashmar and include the following steps:

- background information on the organisation: geographical locations; type of operating systems and computerised functions; external environment (such as the legal and regulatory framework); organisation and management; personnel issues, etc.;
- assessment of financial controls on inputs; processing of transactions; outputs; computer security including systems updates; electronic data processing procedures, etc.;
- description of the organisation's accounting systems, in particular whether adequate accounting records are maintained and whether the systems provide an adequate audit trail;
- identifying the key controls which operate for each account area in the organisation, such as reconciliation of invoices to payments; transactions authorised by a proper signatory; supervisory checks on cheques and supporting documentation; bank account reconciliations, etc.;
- identifying serious control weaknesses, for example where no key controls exist for an account area;
- deciding on how to follow up any deficiencies with the ministry or agency involved.

In monitoring and evaluating the effectiveness of management controls, both the organisations themselves (including the internal audit function) and the external auditors will use a range of information sources. These include:

- the knowledge of individual managers gained from the day-to-day experience of managing their programmes and resources;
- internal management reviews;
- reviews of financial systems prepared by a ministry or by an external auditor or other body;
- programme evaluations;
- parliamentary or congressional reports;

- reports by the SAI, including audits, inspections, reviews, investigations, etc.;
- plans produced by the ministry or agency - in some countries these are similar to the business or corporate plans prepared by many commercial companies.

Ideally, controls should be closely integrated with an organisation's management structure and with the planning and implementation of the programmes for which the organisation is responsible. Hagvall's study, for example, presents the case of Swedish government organisations in which, traditionally, management controls were carried out in the form of pre-audit by special units that were separate from the line organisation. Nowadays, however, as part of the process of decentralisation in Sweden, controls are built into the line organisation itself.

8. A comparison of practice and experience in different countries

Authors of papers were requested to describe the main features of the management control systems in their countries on the basis of the following six questions:

- Which organisations, inside or outside of government, are responsible for developing and promulgating standards for management control systems?
- Are these standards laid down in legislation or defined administratively? How are they promulgated? How much flexibility is given to the heads of government organisations to adapt the standards to their own management needs?
- What are the respective roles of the SAI and the other central agencies (particularly the finance ministry) in promulgating standards of management control, monitoring performance against them and promoting best practice?
- To what extent have countries implemented the general and detailed standards recommended in the INTOSAI Guidelines?
- How is the performance of management control systems monitored and evaluated? What is the role of internal and external audit in this process? How effective (and cost-effective) are the systems?
- What arrangements are in place for ensuring that managers and staff have the necessary resources, skills, and training programmes to operate effective management control systems?

All the countries reviewed in this volume appear generally to comply, implicitly if not explicitly, with the principles and standards for management controls described in the INTOSAI Guidelines. However, it is also clear that there is considerable diversity in the ways in which different countries develop, promulgate, and operate their control systems in practice. This partly reflects constitutional differences (for example, whether a country has a parliamentary system of government, as in European countries, or a system based on the separation of powers, as in the United States), partly the huge diversity of political, legislative, and cultural influences and public service management structures. Some of the main differences are described below.

Canada

Formal responsibility for management controls in the Canadian government rests with the Treasury Board, which issues advice and guidance to ministries and agencies on accounting and financial management issues. In recent years, however, the Treasury Board has introduced more flexibility in the application of management controls at the level of the line ministry, while taking account of the risks involved. It has sought to increase the accountability of ministries and agencies in exchange for greater decentralisation -- a development of the "new public management" referred to above. This change in approach has entailed placing emphasis on developing separate frameworks for business planning, quality services, and accountability rather than on creating a new control framework.

Responsibility for monitoring and evaluating the performance of management controls lies with the ministry or agency concerned. Each ministry has its own internal audit and evaluation group, which reports to the head of the organisation or to an audit committee. The Auditor General's Office also has considerable influence: its role is to assess, on behalf of Parliament, the adequacy of management controls and to report on deficiencies and opportunities for improvement. Such reports are public documents, attract considerable interest in Parliament (particularly in the Public Accounts Committee), and may encourage ministries to remedy deficiencies and/or the Treasury Board to improve its framework for management controls.

Denmark

The Danish system is very decentralised. The Ministry of Finance issues a broad framework of rules and guidance on accounting procedures and management controls to ministries and agencies which are then required to develop their own detailed systems. An agency of the Ministry of Finance provides accounting services to the government sector. The management control systems developed by ministries/agencies are open to public scrutiny. There is no centralised system for monitoring or evaluating the effectiveness of the control systems in individual ministries -- this is generally done through the internal audit procedures of the ministry/agency concerned -- and no central arrangements for promulgating information or advice about "best practice" systems. The Auditor General's Office, however, may report to the Public Accounts Committee in Parliament any shortcomings in management control systems identified as part of its regular financial audits of ministries/agencies.

Germany

The German system of management controls is very different from that found in the other countries reviewed in this volume. There are no prescribed arrangements laid down by government for developing and promulgating standards for management control systems. Each sector of government, and each government organisation, is responsible for developing its own management control arrangements. Given the hierarchical structure of German public administration, authority for decision making is divided among different levels of administration. A higher-level authority is usually in a position to instruct a lower-level authority to introduce specific management control systems and to supervise their application. These arrangements appear to allow sufficient flexibility, in practice, for government organisations to design management control systems to fit their own requirements.

The Federal Court of Audit (*Bundesrechnungshof*) plays an important role in ensuring that government organisations develop effective management control systems. Should the Court discover deficiencies in management controls in the course of its regular audits of government organisations, it can recommend changes in the arrangements. Although it has no legal authority to enforce such

recommendations, the Court brings its strong influence to bear and, in extreme cases, may report its findings to Parliament. Moreover, it uses its influence to ensure that all rules and regulations concerning the performance of government organisations contain management control provisions. This is possible because, in the German system, the Court has to be consulted before administrative regulations concerning the implementation of the Federal Budget Code (regulations with public expenditure implications) are passed. As part of its regular audits, the Court also makes sure that such regulations concerning management control are strictly enforced.

Netherlands

The highest authority for management control in the Dutch government is the legislative authority of Parliament, as described in the Budget and Accounting Act. Parliament also provides instruments for management control in other legislation (such as the National Welfare Act). The Ministry of Finance has responsibility, under the Budget and Accounting Act, for laying down broad standards for financial accounts and management controls. However, line ministries are required to develop the detailed procedures, with the most senior civil servant (the Secretary General) being directly accountable for the quality and effectiveness of his ministry's systems. Each ministry also has an Audit Committee, with responsibility for the organisation's financial management, management control, and departmental audit. In the mid-1980s, following evidence of widespread deficiencies in management control systems, a "Government Accounts Reform Operation" was launched. This has resulted in significant improvements in management controls, departmental audit procedures, and the circulation of financial information within government and between government and Parliament.

The Netherlands Court of Audit (*Algemene Rekenkamer*) has no formal role in the development or promulgation of standards on management control. However, the Court is indirectly involved in the performance of management control systems because its audits are systems-based. It takes a broad view of its role, namely to improve the efficiency and effectiveness of government functions; it does not simply audit state revenue and expenditure in a narrowly defined sense. Thus the financial audits carried out by the Court over the last few years have been extended to include administrative systems and financial management. In practice, the Court's audits are mainly based on the findings of the internal audit service of the line ministries.

Sweden

By OECD standards, Sweden has an unusual, and highly decentralised, system of central government. Less than 1 per cent of civil servants work for ministries; 99 per cent are employed by agencies which have been given a high degree of autonomy in relation to the ministries.

The government issues broad guidance on management controls in the form of regulations backed by legislation. However, overall responsibility for the financial management and auditing of agencies rests with the Swedish National Audit Office (RRV) which thus has a stronger role than in most countries. An important part of the RRV's work on financial management is to develop specific and detailed management control standards for each agency. Agencies are then expected to develop the control procedures necessary to ensure that these requirements are satisfied. The head of each agency is responsible for monitoring and evaluating the effectiveness of the agency's management control systems, which are subject to regular audit by the RRV. When deficiencies are revealed, or when significant issues of principle or practice are raised, the RRV may decide to inform the government. Further, Parliament frequently asks for information about the RRV's audits.

United Kingdom

The main bodies concerned with management control systems in the United Kingdom are the Treasury, the National Audit Office (NAO) and the Public Accounts Committee (PAC). The Treasury is the government department responsible for determining how public expenditure as a whole should be controlled; the NAO is responsible for the external audit of public expenditure by central government; and the PAC is responsible, on behalf of Parliament, for overseeing that proper control is maintained over public expenditure.

The principal means by which the Treasury has promulgated standards for management control systems is a manual entitled *Government Accounting*. This manual sets out the principles governing accounting and management control systems over the whole range of government activities, though detailed implementation of the guidance is left to departments and agencies. The manual also defines the key role of the accounting officer -- the most senior civil servant in a government ministry or agency -- who has personal responsibility for the propriety and regularity of his organisation's finances and accounts, for prudent and economical administration, for the avoidance of waste and extravagance, and for the efficient and effective use of the organisation's resources.

In its regular financial audit work, the NAO may draw attention to deficiencies in the management control system of a department or agency if it believes that they have an adverse effect on the organisation's accounts. The NAO also carries out value-for-money examinations, one of the main objectives of which is to establish whether there are sound management control systems in place to ensure economy, efficiency, and effectiveness. The PAC often uses these reports as the basis for questioning the department's accounting officer on the issues raised. The Committee then publishes its findings, together with recommendations for further action. These often point the way to the need for improvements in management control systems.

United States

The U.S. approach to management controls is highly fragmented. Some basic provisions (for example, accounting for government receipts and expenditures) are provided for in the Constitution. Other management controls have been established in specific laws enacted by Congress. These include the creation of the General Accounting Office (GAO) as the supreme audit institution, and the Office of Personnel and Management to regulate government personnel policies and practices. Other laws requiring financial audits and annual assessments of management controls have been enacted.

In theory, the central agencies should play an even more important role in developing effective management controls in the United States than in most other countries. This is because the most senior management positions in government agencies are usually held by politically appointed officials, with limited tenure in office, who have little or no practical experience of managing government organisations. Against this background, the leadership required from the central agencies in creating an efficient system of management controls has often been found lacking. Another problem is that Congress vigorously protects its authority over the operating agencies and often acts to insulate them from what it, and these agencies, consider to be interference from the central agencies.

Until recently, the audit of an agency's management controls was largely the responsibility of the agency, supplemented on occasion by GAO audits. However, these procedures have been strengthened by two important pieces of legislation. The Federal Managers Financial Integrity Act of 1982 requires the head of each agency to conduct an annual appraisal of the agency's management control systems, to report

the results of this appraisal to the President and Congress, and to make recommendations for correcting deficiencies. The Chief Financial Officers Act requires an annual financial audit of the 24 largest agencies, with the audit report to include an assessment of management controls.

9. Conclusion

The papers in this volume include much valuable information about the management control arrangements operating in different countries and the way in which the effectiveness of these systems is audited and evaluated. It is clear that there is no single model or approach that applies in all cases. This is likely to be as true for the CEECs as it is for the countries reviewed here. Although most countries have adopted -- explicitly or, more often, implicitly -- the key INTOSAI principles and standards, these have been adapted to fit the particular constitutional, political, legislative, and cultural characteristics of the country concerned.

Areas in which differences in approach among countries appear to be particularly marked include:

- the definition and role of internal audit;
- the extent to which countries have decentralised their management controls in accordance with the principles of the "new public management";
- the extent to which controls are promulgated by means of primary legislation, regulations backed by legislation, or administrative procedures;
- the extent to which management controls are built directly into decisions on government expenditure programmes or are developed independently;
- the constitutional status and role of the supreme audit institutions and the extent to which they operate independently of government.

Building an effective structure of management controls is difficult. The more complex the system of government and the inter-relationships with other parts of the economy, the more complicated and extensive the management controls that are required. Moreover, as Havens points out in his study, well-intentioned legislation or administrative provisions can have perverse effects. The Inspector General Act, for example, was intended to strengthen the internal audit and investigation functions of the United States by making the Inspectors General accountable to the President and Congress. Instead, it has created divided and potentially conflicting loyalties.

MANAGEMENT CONTROLS IN CENTRAL GOVERNMENT ACTIVITIES : A SWEDISH PERSPECTIVE

by
Jan Hagvall²

Executive Summary

A fundamental objective of the Swedish system is that the citizens should have faith in central government activities and be able to examine them critically. The decentralisation of central government activities has been carried out with the aim of making the agencies more efficient and of moving the decision-making process closer to the individual citizen. Under the law, all agencies serve the citizens and provide them, on request, with information about their activities. The management controls in the agencies must safeguard this right.

Management controls in the agencies were previously carried out to a large extent as pre-controls performed by special units which were not part of the line organisation (for example, checking that a bill could be paid, that grants of a certain amount could be paid to specific recipients, etc.). Today, the controls are most often built into the line organisation and serve a broader purpose.

The Swedish National Audit Office (RRV) is responsible for external auditing in the central government sector. Since resources are scarce, the auditors must analyze the risk situation, identify the audit issues that should receive priority, reconsider the audit plans where necessary, and carry out the audit work as efficiently as possible. Furthermore, to enable agencies to benefit fully from the audit, professional co-operation between the external and internal audit functions should be increased. A government regulation introduced in 1995 requires the largest agencies and agency groups to maintain an internal audit function that meets certain stipulated demands.

The RRV's audit reports are addressed to the lowest level at which it is certain that effective action will be taken. The government is informed in serious cases, if the agency audited reacts slowly, and in every case where principles and the general interest are concerned. Today, Parliament frequently asks for information about the RRV's audits.

With regard to the procurement work of agencies, it is important to improve the general controls available to management, with regard, for example, to plans and budgets, evaluations, the skills and qualifications of the personnel concerned, and documentation. By their examination of the management controls in agencies, the external auditors contribute to safeguarding management's ability to monitor procurement work and to a better understanding of the processes involved.

² As an audit director at the Swedish National Audit Office, the author is responsible for the audit of all government agencies within the area of responsibility of the Ministry of Finance. The National Debt Office, the Swedish Customs, and the National Tax Authorities are some of the most important agencies in this area. The author has undertaken special assignments in the fields of finance and administration on behalf of the Ministries of Finance, Health and Social Affairs, and Labour. His most recent report to the government stemmed from a commission he led in 1994, which dealt with the need for improvements in management controls at central government agencies.

If decentralised procurement is to succeed, there has to be understanding of control by management, competent units in the agencies with appropriate expertise in the procurement field, and basic skills in financial/administrative matters within the units. The agencies have to meet demands for the application of commercial principles, for competition, and for objectivity in the central government procurement process.

1. The framework for management controls in Sweden

Control of central government activities

One important prerequisite for effective control of central government activities in Sweden is the capacity to carry them out with substantial openness and ample opportunities for inspection. Anyone should be able to examine the government's activities critically. Government and agency documents are, as a rule, registered, so that the general public can gain access to them. Secrecy can be invoked only on certain clearly specified grounds that have been established by law. It is vital to keep these principles unchanged, even with Swedish membership in the European Union. Free and independent media need to be able to subject the central government administration to critical examination. The light they shed on government activities safeguards compliance with the law and effectiveness. In turn, this requires pluralism in the media and strong defences to maintain the freedom of the media against political control.

The political assessment of central government activities by Parliament is partly performed by the Standing Committee on the Constitution with the support of auditors selected among the members of Parliament. The parliamentary auditors are supported by a small audit organisation consisting of less than 50 professional auditors. The purpose of this organisation is to enable the various standing committees of Parliament to play a more effective role in assessing central government activities. In addition, in individual cases, the office of the Parliamentary Ombudsman provides assistance to citizens who wish to assert their rights against the agencies.

Most of the central government's professional auditing resources are located in the RRV, which is responsible for the regular external audit of the accounts and management control systems of all central government agencies. The Chancellor of Justice is the government's equivalent to the Parliamentary Ombudsman, but he has some additional tasks that cannot be considered to involve administrative controls.

Government organisation in Sweden differs from that in most other countries. Sweden's central government administration is characterised by very small ministries. Less than 1 per cent of the 300 000 central government employees work for the ministries. The agencies working within the different fields of competence of the ministries have a high degree of independence from the ministries. The central government agencies are responsible for making their own decisions in cases that involve the application of the law and the exercise of public authority. Each agency, headed by a director general, is responsible to the government and, in practice, to the minister concerned in its day-to-day work.

Development and promulgation of management controls

The Swedish government promulgates regulations, as second-level legislation, which are important for the management controls of agencies. These regulations lay down the principal goals of controls. The government is collectively responsible before Parliament for ensuring that controls in the independent central government agencies are in accordance with the decisions of Parliament. The division of central government activities in Sweden into a "purchaser function", for which the government is collectively responsible, and independent central government "performance agencies" has meant that, comparatively speaking, central government activities have been widely decentralised. This circumstance has been considered to increase the need for controls within the Swedish administration.

Role of central agencies

Sweden has an unusual system, in that the overall responsibility for financial management and auditing within the government sector rests with a single organisation, the RRV. The RRV determines the basic accounting standards for all agencies. The agencies are responsible for implementing these standards, and the RRV then audits their accounts. Another vital part of the RRV's work on financial management is to develop standards for management control systems in central government agencies. The standards are published in guidelines and instructions for the accounting systems of the agencies. These standards are developed, defined, and issued by the RRV. The RRV then ensures that the agencies comply with the approved standards through its auditing activities. Furthermore, the RRV provides the government with the up-to-date information it needs as background for its decisions on economic and budgetary policies. It also supports agencies' performance through its audits and advisory services.

The heads of government agencies have a certain amount of flexibility for adapting standards to their own management needs. Some detailed standards are obligatory, for example in the case of special financial operations. On the other hand, it is up to each agency essentially to decide its human resource management standards, within given financial limits. The most important Swedish standards for agencies are discussed below.

First, the government regulations mentioned above provide a very general framework of guidance for all agencies. The agencies are expected to manage their activities so as to satisfy certain obligations laid down by the government in accordance with decisions of Parliament contained in the following documents:

- a statement of the main duties and responsibilities of all agencies;
- specific instructions on the duties and responsibilities of each agency;
- a spending authorisation sent annually to each agency, which specifies the funds available to the agency and describes specific tasks, which may change from year to year;
- an obligation for each agency to produce annual accounts and provide information about the financial performance of the agency and its outputs.

Second, more specific and detailed guidance is given on the preparation and presentation of accounts and on the management control procedures which agencies should implement. This guidance is mainly issued by the RRV and supplements the general framework.

Third, each agency is expected to develop its own management control procedures to ensure that the requirements described above are met. These should include, for example, instructions on how the work of the agency is to be organised, the allocation of responsibility to individual managers, and the production of annual accounts and activity plans.

Comparison with INTOSAI Guidelines

Swedish agencies have implemented standards similar to those laid down in the INTOSAI Guidelines for Internal Control Standards. It is vital for the agencies to ensure that the Government's annual demands will be met within the laws and funds available. Among many important aspects the agencies' management controls cover the connection between the government's intentions and the goals of

the agencies' activities, the capacity and explicit lines of responsibility within the agencies, the agencies' carrying out of tasks in a manner that maximizes results and minimizes the risk of important errors and irregularities.

Monitoring and evaluating management controls system

The head of the agency is responsible for monitoring and evaluating the results of management controls according to the standards mentioned above, which are comparable to those of the INTOSAI Guidelines (I, para. 1). Furthermore, the RRV, as external auditor, audits regularity and efficiency. The importance of internal audit is growing and now receives more resources than before. The internal audit teams are intended to contribute to the quality of controls, especially in larger agencies. The government has decided that, from 1995, the large and important agencies will be required to maintain an internal audit function with certain stipulated characteristics (see Section 3, under "Strengthening of internal audit").

Resources, skills and training for implementing management control systems

To construct and operate an effective management control system, it is necessary to have professionally trained personnel able to use organisation theory and to evaluate models for that purpose. The RRV works a great deal with development programmes for managers and staff, at both individual and group levels. The agencies co-operate by using the available experts in the most effective way. The management control systems still focus on financial matters, but the situation is changing and more attention is being paid to results achieved.

The greater freedom of the agencies, in terms of handling of funds, combined with extensive decentralisation, places great demands on their responsibility and professional skills. At the same time, the agencies are expected to make greater efforts to produce satisfactory results. These circumstances affect the emphasis of the RRV's audits. For the foreseeable future, the agencies' results will be of central importance in the audits.

2. External controls through independent professional audits

The RRV's audit mandate

The government's collective decisions, combined with full public access to all documents relating to the activities of the agencies, counteract, where the government's work is concerned, the risks related to decision making at this level. Against this background and taking into account the extensive decentralisation of central government, it can be said that the greatest risks lie in the activities of the central government agencies. The RRV's audit mandate covers the government agencies and a growing number of central government companies and foundations. In 1994, the RRV had 260 auditors, i.e. less than one auditor per thousand central government employees.

The RRV is substantially independent from the agencies in all important respects, since its audits normally are fully funded by the government. Thus, there are no financial ties between the RRV and the agencies audited. The RRV differs in this regard from private auditing firms, which do have financial connections with the organisations they audit. As an autonomous agency and an independent auditor, the RRV carries out audits, without government involvement, on the basis of generally accepted auditing standards and its own professional code.

The independence of RRV audits is decisive for the faith that is placed in the RRV as an auditing body. This is also an important prerequisite for its international undertakings, particularly for its relations with other supreme audit institutions.

RRV audits include regular examinations of the agencies' annual reports. The RRV also performs studies which draw attention to obstacles to the effective and efficient use of resources in the government sector. It provides Parliament, the government, and the agencies with information that enables them to make decisions to improve efficiency.

During recent years, the audit work of the RRV has been characterised by extensive support to the government and the agencies audited. The efforts made in this respect have been significantly greater than the general advice that should always be provided in connection with an audit. The reason for this shift in emphasis is that the audit also includes the task of supporting, and following up the results of, the comprehensive measures taken in order to improve the operation, control, and accounting of central government activities. The RRV carries out its main task, the audit, but also provides advice where it feels that action can have an effect (I, para. 80). This places great demands on the auditors, with respect both to their professional skills and their integrity in the practice of their profession.

A substantial majority of the agencies now have proper accounting systems in place. The transition to the new financial and result-oriented control of the agencies has been smoother than expected. Nevertheless, it has been noted there are still shortcomings in the management control systems described below. They are often related to the fact that financial responsibility has been decentralised or that the agency is being closed. Questions have arisen, for example, about public procurement, financial operations, part-time jobs held by civil servants, etc.

The audit work

The particular audit issues to be given priority are identified by risk analyses. This process is of great importance, since scarce audit resources must be used efficiently. The audit should follow good auditing practice, that is, the scope of the audit should be sufficient and sound professional principles should be applied. The criteria of significant operations and risk exposure and, of course, the experience of the auditor(s) concerned, are factors that influence the audit approach. The RRV is devoting more time to improving methods for assessing the audit approach.

Each part of the audit is carefully planned. The audit plan specifies the most important problem(s) to be investigated, the skills needed in the audit team, the amount of time required, the date by which the audit is to be completed, costs, and internal reporting and reporting to the agency audited and the government.

The audit is prepared well before the agency is actually visited. Through electronic data processing (EDP) network systems, the RRV has good access to the current accounts of the agencies. These are analysed, and questionable transactions are noted. Other available information about the agency is collected. The accounts of the different units and departments in the agency are compared. A list of questions to be asked during the visit is prepared. And so on.

This systematic approach minimises the time needed at the agency. The visit is used for interviews and for studying different kinds of documents in order to verify or reject what the current accounts and other information has indicated. The time is also used for investigating the management control systems, especially how they have been implemented.

Finally, the results of the audit are reported. The principle for reporting results is that the report is to be addressed to the lowest level at which it is certain that effective action will be taken. The government is informed in serious cases, if the agency audited reacts slowly, and in every case where principles and the general interest are concerned. Today, Parliament frequently asks for information about the RRV's audits.

3. Management controls in central government agencies

Consequences of the decentralisation policy

Today, central government activities are carried out with various degrees of freedom, with regard both to financing and objectives. Detailed regulation of resources is exceptional. The objectives of the activities of central government agencies are based on the political objectives set by Parliament. For each activity, performance indicators make it possible to check and follow up the results of the activity. The decentralisation of central government activities has been carried out with the aim of making the agencies more efficient and moving decisions closer to the individual citizen.

Controls performed within agencies were previously carried out to a large extent through pre-controls performed by special units that were not part of the line organisation (for example, checking that a bill could be paid, that grants of a certain amount could be paid to specific recipients, etc.). Today, the controls are most often built into the line organisation. The decentralisation of responsibility for the use of budgeted resources is connected to a decentralised control system. The head of a line unit may only approve a payment if a certified voucher exists, if the payment concerns the area for which the unit is responsible, and if it is under the ceiling amount specified by a superior officer. This applies to both pre-controls and follow-up controls. In addition, follow-up controls are increasingly performed through external audits, that is, through an examination that is independent of the organisation.

It has long been a basic feature of management control that information about agencies' accounts and performance gives a true and fair picture, and that mistakes and problems are revealed and corrected. As electronic data processing technology and telecommunications have developed, the controls have expanded. Today, management control encompasses all activities within an agency. It is now possible for management to monitor and analyze activities continuously, in addition to taking corrective measures when necessary. The decentralisation policy, the limited resources available, and the increasing demands for follow-up all contribute to a greater need for management controls, as the preface to the INTOSAI Guidelines underscores.

It is the director general of an agency, reporting to the relevant ministry, who carries the main responsibility for ensuring that the intentions of Parliament and the government are fulfilled with respect to the law, that the funds allocated are properly used, and that activities are accounted for in a true and fair manner. In order to achieve this, the necessary controls have to be built into the agency's organisation, systems, and work routines as well as into the attitudes held within the agency, so that the proper administration of assets is promoted and proper management controls are maintained. The heads of the agencies must understand the structure of the management control system and the goals that the controls are to achieve (I, para. 3).

Shortcomings

The heads of the agencies need to expand the management controls for the activities under their responsibility, in order to meet these demands, which concern activities that have become increasingly complex. Advice in this connection has been a recurrent feature of the RRV's external examinations of the agencies and of the RRV's reports to the government on the financial and administrative state of central government activities.

A brief review of a number of problems which have entailed significant risks in the activities of the agencies, and which have not been dealt with in an acceptable manner through management controls, is given below. It provides information about current control issues, primarily financial and accounting issues. It thus provides a representative picture of current risks in central government activities. The risks are of a type that can be dealt with in basically all important respects through an expansion of controls in accordance with the detailed standards given in the INTOSAI Guidelines (I, para. 4). It is fair to say that many agencies have already taken action against deficiencies by improving management controls.

The handling of grants

Grant funds are to be used for their intended purpose. For example, grants for regional development projects, which are the responsibility of the county administrative boards, have been improperly allocated to the financing of expenses for internal administration, to the relocation of the county administrative boards' own activities, etc. Within the fields of technology, regional policy, and new energy technology, the control systems are inadequate. They fail to prevent grants being given to unqualified recipients and to ensure that grants are used for proper purposes. Furthermore, deficiencies in the controls have been observed when organisations outside of central government have been used to distribute central government grants. Decentralisation and/or delegation increase the difficulty of constructing appropriate controls for the handling of grants.

On the basis of the RRV's observations, the government has required agencies to repay grants that have been incorrectly disbursed. This has been done by reducing the annual appropriations for staff and administration of agencies that have made such mistakes. The RRV has advised the government on how to improve its directives for the administration of grants.

The handling of financial transactions

Decentralisation often leads to the transfer of responsibility, and authorisation to handle financial transactions is given to personnel who are not accustomed to working in this area. The responsibility for handling liquid assets, which can amount at times to millions of kronor, can be transferred from a handful of centrally located persons to perhaps ten times as many persons who are insufficiently qualified or whose qualifications may be totally different from those needed for this type of task. This is a change that has significantly increased the risk of payments being made to the wrong recipient, at the wrong point in time, without formal approval, or for an incorrect, and perhaps even improper, purpose. This does not mean that decentralisation itself is being questioned; rather, what is being pointed out is the need for strict management controls.

The RRV has drawn attention to this problem in audit reports in 1993 and 1994, in particular at agencies with a structure which can be likened to a group, that is a parent agency with up to hundreds of regional and local subsidiary agencies. It has noted that the agencies have improved their controls, although further measures are required. The RRV is keeping the problem under close observation. However, it is no longer an issue for which the RRV wants the government to introduce special measures.

Conflicts of interest and similar situations

It is common for an agency employee to have tasks or interests beyond his or her job at the agency. Decentralisation and/or delegation of responsibility and powers create greater risks of conflicts of interest and similar situations. One such situation arises when civil servants, in the course of their duties, are improperly affected by their spare-time occupations. This is particularly true for universities and technical institutes, where many employees have second occupations. For example, university employees may own companies that have business relations with their own university. Such situations, which in themselves are questionable, can mean that employees, on behalf of their university departments, favour their own companies in a bidding process. The public's faith in civil servants can be shaken by problems of conflict of interest if agency management is unable to apply the Administrative Act's rules on conflict of interest in the agency's internal control system. Conflicts of interest and part-time occupations still pose a serious problem, especially in universities.

In an audit at one of the country's universities concluded in 1994, the RRV has required the university to survey the full extent of the problem and to ensure that existing rules are observed. The university has appointed a special officer to investigate the problem. The university management has also prepared new directives which emphasize the existing rules. In the Cabinet Office, a special group on side-line occupations has been formed, with the aim of drawing up proposals for a government decision on stricter rules for such occupations throughout the educational field. The proposals will be based on the results of the RRV audit.

Reliability of EDP systems

The agencies tend to be too dependent on their data processing functions. This creates great risks for the reliability of the data used in financial accounting, etc. It is still the case today that agencies' data processing expertise is often the exclusive preserve of special units/functions. The demands made on these units in terms of production and performance can affect the control of transaction and production flows. This situation can easily occur if the rest of the organisation is unable to follow up and determine whether or not the data processing function has carried out its duties with sufficient care and quality. There is a risk that the lack of expertise within the remainder of the organisation, and especially among management, will lead to a situation where far too elementary demands will be made on the data processing function. In order to strengthen management controls, management should engage in continuous evaluation of the systems, programmes, and testing procedures, with the aid of independent data processing experts.

Rapid changes in the legislation and regulations pertaining to a policy field also result in requirements for rapid changes to processing routines, the data processing system, and the system's mechanical controls. Through changes to processing routines and through various testing procedures prior to the commencement of operating procedures, it is possible to avoid problems. Failure to do this properly can lead to substantial risks of defects, and thereby problems, for example with financial follow-up controls. Follow-up results based on inaccurate or misleading information can in turn lead to faulty decisions. The management control system should include controls that ensure that the information on which decisions may be based is accurate.

Central government has invested in large data processing systems for the administration of tax collection and the social insurance systems, for example, as well as for the administration of private and central government funds. Practically every agency uses data processing as a tool for its financial administration, project follow-ups, and many other purposes. One recurrent problem is that too many employees have been given the general right of access to these systems. The daily handling of access cards constitutes a problem, in that too little attention is paid to security needs. For example, the cards can be left in the terminals. This unnecessarily increases the risk that data processing information will be used in an improper manner and that information will disappear or will be distorted. In all too many agencies, security of access routines related to data processing systems is deficient.

One of the most important tasks of the RRV is to examine the agencies' EDP systems. As can be seen from the above, the RRV has observed shortcomings in the exercise of proper controls over EDP systems. The RRV has also demanded thorough testing of EDP systems before they are put into operation, safeguarding the security of access routines to EDP systems, etc.

The function of EDP systems is a strategic and complicated issue for the government to deal with. Individual agencies are not capable, in the short term, of investigating and solving all the problems associated with this issue with their own resources. The RRV has set up a special group to strengthen the audit of the agencies' EDP systems. This group works together with the RRV's other auditors. The government can now take stronger measures in the EDP field on the basis of the RRV's in-depth audits in this area.

Controls in the processing of matters that affect several agencies/institutions

Where matters that are to be processed by more than one agency are concerned, it has been shown that it is difficult to maintain satisfactory controls. The explanation can be found in the uncertainty as to where the responsibility of one agency ends and that of the next agency begins. This situation may result in unfortunate financial consequences for central government. For example, a company that has paid too much value-added tax can receive a refund from the tax agencies even though it has debts that are due to other central government agencies. With good management controls, and without new legislative measures, the problems related to unpaid debts could be reduced significantly.

It is particularly important to maintain good controls when central government agencies are closed down or restructured. Since this is an extraordinary situation, there is a risk that the agency will not have satisfactory routines, for example for the sale of assets. In one case, the sale of such assets was taken care of by the agency's purchasing office. The transformation from buyer into (less experienced) seller created a situation in which the sales transactions exposed the agency to substantial business risks. In addition, defective billing routines resulted in errors in the accounting of the revenues generated.

On the basis of the RRV's observations, the government has now stipulated that, when claims for payments from companies fall due, for example for value-added tax on imported goods, the Swedish Customs must hand these matters over much more rapidly to the tax collection authorities. Only these agencies can clear different types of payments between government agencies and private companies. The government has made significant gains by allowing the tax collection authorities to enter the process at an earlier stage and to deduct the government's claims against the companies' requests for tax refunds.

Procurement

Weaknesses in the agencies' systems for procuring goods and services constitute a serious problem. However, the seriousness of procurement problems varies. A great deal of action has been taken to improve procedures. Nevertheless, difficulties still arise. Section 4 gives a detailed report on the procurement process and the establishment of relevant management control systems. Major weaknesses in the procurement process are also outlined. Different control procedures in the process are also linked with the standards of the INTOSAI Guidelines (I, para. 4).

Sweden has now introduced stricter and more comprehensive rules for public procurement which correspond to those in force in the European Union. The stricter sanctions mean, among other things, that the procuring agency can be obliged to recommence procurement or pay considerable damages to a wronged tenderer. The new conditions increase the demands on both the management of agencies and the RRV to nullify procurement that does not follow the rules in force.

Strengthening of internal audit

The problems described above have been reported in a regular manner to the agencies audited. Certain agencies have taken proper action. On the other hand, the RRV has drawn attention to similar problems for several years. This led, in 1994, to a government decision to commission the RRV to investigate the need for measures to improve management controls at government agencies. I was responsible for the investigation, which was carried out from May to December 1994. As a result of the study, there is now a government regulation requiring the largest agencies and agency groups to have an internal audit function which meets certain stipulated demands (I, paras. 74, 78, 84 and 85). These include:

- internal audit must examine the controls exercised by the agency in its systems, its routines, and its organisation, and how it meets its obligations in terms of its accounting;
- the boards of agencies, in certain cases the director general of the agency, must approve the annual audit plan;
- the plan must be based on an analysis, performed by internal audit, of those activities for which the danger of substantial errors is greatest;
- approval of the plan is to be given after consultations have been held with the RRV;
- the internal audit is to be performed in accordance with generally accepted professional standards;
- the internal auditors are to report their observations to the board of the agency, or, where there is none, to the director general of the agency.

The government regulation will oblige the agencies to work with more controls and more security. The regulation does not by any means replace management controls in the line organisation or elsewhere.

4. Aspects of management controls in the field of procurement

The RRV believes that Swedish experience, especially in the field of procurement, can be applicable to other countries, despite differences in legislation and other regulations among countries. The RRV has concentrated in particular on the agencies' procurement of consulting services. This area illustrates the agencies' increasing dependence on a technologically complex environment. This environment must be managed and used in the best manner possible, among other things through the professional procurement of expert services that may be necessary from time to time in the activities of agencies. In many ways, the procurement procedure and the problems associated with it apply equally to goods and services. However, experience has shown that it has been more difficult for government agencies to administer the procurement of services.

As an external auditor, the RRV has a significant role in the follow-up controls of central government activities. Yet, the example shows, above all, how important it is for each agency to treat follow-up controls seriously as a part of their management control.

Procurement in figures

At the end of the 1980s, the total procurement of central government agencies, government corporations, and public enterprises was estimated to be about SKr 100 billion, more than 50 per cent of consumption and investments in this sector.

The government imposes general requirements on agencies in terms of cost effectiveness, which is an important issue in the procurement of goods and services. The attention paid to procurement by the agencies has its basis, among other things, in national and international experience that discrimination in procurement is quite common. Estimates produced by the European Commission in the late 1980s indicated that, as a result of protectionist measures, the citizens of the member states paid about ECU 40 billion too much annually for the public procurement that took place in their respective countries. In a Swedish government study made in the beginning of the 1990s, it was pointed out that there was a potential for increasing efficiency -- estimated at somewhere between 10 and 50 per cent -- to be realised through increased competition for procurement.

Competition is an expression of the application of commercial principles, and it plays a major role in central government activities. All financial matters are to be dealt with within the framework of the applicable rules in the Public Procurement Act, on the basis of sound business principles, and without unnecessary delays.

Behaviour on the procurement market

Increasingly complex goods and services are being offered on the market. This, in turn, increases the qualifications required of central government purchasing officers, among others. The suppliers offer packages of goods and services, such as education and training in combination with computers and computer installations. The range of services offered by organisation consultants, advertising agencies, accounting firms, and others is increasing. The quality of the services varies widely. This situation creates cost trends that are difficult to follow and analyze.

The complexity of the goods and services makes it necessary for agencies to devote a great deal of effort to learning and analysing what the market offers, which suppliers are on the market, to examining the extent to which the agency can do the work itself, and to choosing between the alternatives. Offers

made by suppliers are to be subjected not only to competition but also to critical examination. At the same time, it is important to realise the synergy effects of co-operation between clients and suppliers. Integrated relationships between clients and suppliers are sometimes preferable to developing the expertise needed to determine which products should be used. In addition, the decentralised activities of agencies intensify demands on management to scrutinise procurement.

A significant element in the management controls of agencies is ensuring that procurement processes function satisfactorily. This means that each agency should provide advice and information to its managers and others responsible for procurement on how commercial procurement should take place, information which clarifies the meaning of the provisions of the Public Procurement Act and gives concrete form to the specific rules that are to be directly applied in procurement. The management of agencies should also ensure that the Act is actually put into effect.

Step-by-step method for procuring consulting services

Box 1 describes public procurement and its various phases from a control perspective, with the aid of an example of agencies' use of consultants in their activities. It should be pointed out that agencies should use consultants primarily as a specialist resource or as a solution to temporary problems of capacity. The example chosen can also be seen against the background of growth in the proportion of services in overall Swedish public procurement, which currently constitutes more than 50 per cent of total volume, and of the relative difficulty of management control for procurement of consulting services.

Management control includes general controls for procurement and specific controls relating to the various parts of the procurement chain from identification of need to follow-up and evaluation of the consulting input, as well as supervision of these controls. The control programme described does not cover every aspect, but is based on the factors which, over time, have shown themselves to be the most important and over which control should be exercised in the procurement of consulting services.

Experience of agencies' procurement procedures is reviewed below. In the RRV, auditors begin their audit by considering procurement questions in the context of the overall control system of the agencies. Depending on the circumstances in each individual case, the RRV chooses to examine the agency's supervision of its control activities, how it works with its general controls, or how the agency's controls of certain sections of the procurement chain are functioning. The programme is well in line with the standards detailed in the INTOSAI Guidelines (I, para. 4).

Box 1. Management control and procurement of consultants

The following controls are to be supervised by qualified personnel who have the confidence of agency management.

General controls

Plans, budgets, etc.

Two of the main steering instruments for procurement activities are the planning and budgeting processes. Through the use of an annual budget framework, resources are allocated to the various units in the agencies for salaries and purchases of goods and services. The resources are to be distributed to the units with the objective that the agencies' activities will be carried out in an efficient manner. The units themselves are to be able to influence how the resources allocated to them are to be used. Procurement is to take place in a cost-effective manner.

Certain restrictions are needed on the units' use of resources for procurement and are to appear in plans, budgets, and other decision-making documents. The agency's policy as to whether it will produce the service itself or use outside contractors is to be followed, and contracts signed by a head of a unit on behalf of the agency should not exceed specified ceiling amounts. The right to set these limits has been delegated to the agencies by the government in its instructions for agencies. Above the ceiling amount, the officer immediately superior to the head of unit assumes responsibility. Ceiling amounts for simpler, less formal procurement by the units also exist. Agencies are to use joint purchasing agreements, and computers and other more exclusive data processing equipment are to be procured centrally within the agencies in order to avoid operational disturbances and other problems related to the introduction of computers and computer support systems into the agencies' operations.

One basic condition for procurement is that a single person must not be responsible for several key functions in the procurement process (I, para. 4). The drawing up of tender documents, opening of tenders, evaluation of offers, drawing up of contracts, payments, and accounting are such key functions. Furthermore, the various parts of the procurement process are to be reconciled continuously throughout the year.

The control and evaluation of the input of consultants

A consultant who has been engaged by an agency is not to perform an assignment completely on his or her own. The agency must allocate resources for control purposes to ensure that the results of the consultant's work are satisfactory.

The follow-up and evaluation of consultants should concentrate on the most important aspects of each consulting assignment. A register is to be kept of all consultants used. This register is to include the consultant's name, the purpose of the assignment, the actual completion time compared to the contracted period of time for the assignment, an evaluation of results, and the hourly fee for the consultant's services. The evaluation of the consultant's input is an important starting point for the agencies when planning on-going activities.

Issues of qualifications and experience

The management of an agency is responsible for ensuring that the agency has access to appropriately experienced and qualified personnel (I, paras. 28-31). As part of this management task, personnel motivation is important. The management control system should ensure that the experience and qualifications available correspond to current needs. It should also play an active role in the development of activities to make sure that they become more efficient. The field of procurement is one in which the supply of skills and experience has now become an important issue for a number of agencies, owing to the fact that a new Public Procurement Act entered into force at the beginning of 1995, and it must naturally be applied in a professional manner. The Procurement Act is much more detailed than the previous rules. It includes sanctions for inappropriate procurement. These new circumstances mean a major change in procurement procedures, including the need for more controls.

Box 1. Management controls and procurement for consultants (cont'd.)

A management control system, among other things, must clarify how an agency's management strategy for ensuring a supply of personnel with appropriate skills and experience is to be spread throughout the agency by managers responsible for personnel recruitment and development. In addition to education and training, the development of skills can be achieved through professional guidance on work duties, new tasks, and employer exchange programmes between, for example, agencies with similar types of activities. The opportunity to utilise improved skills is a measure of the fact that the skills are valued.

Documentation

The procurement process must be well-documented (I, paras. 4 and 43-47). A fully satisfactory procurement procedure is necessary, in turn, for examining whether or not the other general and specific controls function satisfactorily. The documentation should cover all phases of the procurement process that appear in the control programme and be easily accessible for review.

Specific controls of the various parts of the procurement process

The procurement decision

Before this decision is made, the alternatives to the decision to purchase outside consulting services should be carefully examined. For example, is it possible to solve the problem through a reallocation of internal resources or should new personnel be employed? The agency should start from the position that it is normally expensive to rely on consultants as a means of strengthening existing resources. The agency must allocate time for controlling the consultant's input. Otherwise, the consultant has little possibility of carrying out the assignment in a proper manner.

Choice of the purchasing form

When purchasing consulting services, it is often difficult for an agency to describe the services clearly and fully for tenderers. This increases the need to require the tendering process to be carried out in a formally regulated and documented manner, and with the support of negotiations with the tenderers. When small amounts of money are involved, in situations where rapid decisions have to be made, or where other important considerations are involved, purchasing should follow the simplified procedure specified in the Public Procurement Act.

The documentation for tenderers in relation to the services being purchased

The documentation is to be as clear and complete as possible. It should specify the scope of the task and indicate the applicable commercial and administrative conditions. Where it is difficult to formulate a clear and complete description of the task, the agency should carry out the purchasing process in several stages.

The invitation of tenders

The purchasing agency is to make use of opportunities for competition available for the goods or services that are the object of the tendering procedure. Tenderers are to be treated objectively. Tenders are to be invited from as many suppliers as necessary, given the nature of the task and the competition available on the market.

Box 1. Management controls and procurement for consultants (cont'd.)

Examination of the tenders and the tenderers and choice of the consultant

The examination is to be based on the tender documents, the offers received from consultants, and circumstances which otherwise may have developed in the negotiations with tenderers. The selection process should take into account price and other valid criteria that are assumed to lead to the best results. This decision also includes taking a position with respect to the various consultants involved in the procedure. Before the agency accepts a tender, it should make sure that the tenderer is serious. This means examining the tenderer's ability to carry out business activities, ensuring that tax liabilities have been paid, etc. The reasons for selection are to appear in the tender record or other similar documents.

The contract and the contract terms

The terms of the contract should regulate all the significant issues between the agency and the consulting company engaged for the task. This minimises the possibility of misunderstandings arising on what was actually decided with regard to the contract. The focus and the contract terms of the consulting assignment should otherwise not conflict with the tender documents and the evaluation of the tenders that has taken place.

Reporting to the client

Interim and final reports from the consultant, both oral and written, are to be regulated in the contract.

Payments

Payments are to be made to the consultant after the final report has been submitted, unless other contractual terms have been agreed. The agency officer authorised to deal with the matter must approve payments, but only for contracted tasks that have been completed and accepted. Payments may be approved if they are in accordance with invoices that have been stamped with an arrival date, are specific, and have been authorised for payment by another official (I, para. 4). If the payments are relatively large, double authorisation may be required.

Accounting

The procurement procedure must be accounted for in accordance with generally accepted accounting principles. In other words, the accounting must be current, complete, accurate, comparable, and suited to the particular purpose (I, para. 4).

Major weaknesses when procuring consultants

In their planning and budgeting, the agencies devote too little attention to questions that touch upon cost effectiveness in the use of consultants and in other types of procurement. For many agencies, the use of consultants is an unplanned and *ad hoc* phenomenon, even though substantial resources are spent on such services. Feedback from experience gained from individual instances of consultant procurement is summarised much too seldom to make it possible to introduce more thorough reappraisals of systems and routines for procurement.

For payments and accounting, there is a well-established procedure for regulated and detailed financial controls. However, analyses of financial information in the accounts can reveal significant deviations from the expected results. This may be a sign of underlying and sometimes questionable circumstances that motivate strengthening of management controls. From time to time, improper family or other close relationships are found to exist between the person responsible for purchasing and the consultant engaged; valuable benefits or gifts are sometimes provided to the purchaser, and there may be evidence of favouring or discriminating against certain companies and certain regions. An important task of management controls is to work against these and other types of corruption.

An additional purpose of the management control system is to bring order to the documentation of agencies. Where the documentation has substantial shortcomings, information feedback is made more difficult. This is particularly serious in a situation where the former national Public Procurement Act has been replaced by a new law based on the European Union's somewhat different regulations regarding public procurement. Violations of the regulations need to be discovered and remedied. If the new law is not complied with, the courts can issue an order to stop the procurement process or order the purchasing agency to pay damages.

Management control systems have not secured the skills that are now necessary in the field of procurement. Education and training programmes for the new system of regulations have been insufficient. These programmes have been introduced quite late, in view of the point at which the new Act went into effect.

As external auditor, the RRV expects management control, in the form of follow-up controls, to be carried out in a systematic and analytical manner (I, paras. 76 and 77). Today, this is not sufficiently the case. It is, for example, important to start out from well-founded hypotheses on the risks involved in procurement activities. The hypotheses should be tested through comparison and evaluation of the procedures in the relevant phases of the procurement process. This type of follow-up control is illustrated in the following section.

Follow-up controls when using consultants

First, an agency's high-risk units should be identified. Such units can be identified in terms of three different categories: purchasing profile, vulnerability in purchasing, and organisation.

- *Purchasing profile:* Purchases for large amounts, long-term supplier relations, strategically important purchases, and purchases that from experience lead to problems.
- *Vulnerability in purchasing:* Invoices that are difficult to check, large numbers of invoices, several different types of costs, large numbers of suppliers, patterns that deviate with regard to invoicing, delegation of responsibility, specialised activities, and transfers in the accounting.
- *Organisation:* The activity is highly dependent on purchased data processing services, the core activity employs expensive consultants in addition to its own personnel, overall financial/administrative skills have been neglected, changes have been introduced in financial systems and have led to problems, and reorganisation, rotation of managers, vacant management posts or changes in the agency create new conditions for the activity.

Second is the formulation of relevant hypotheses on an agency's high-risk units, for example, whether strategic purchases are made in accordance with the applicable activity plan; whether commercial considerations are of decisive importance, particularly for major purchases; whether financial controls are of an acceptable quality and the procurement is correctly accounted for.

Third is the testing of the questions asked. In applying these tests, agencies find it helpful to consider the procurement process as consisting of the following ten steps:

- the tender documents;
- invitation to tender;
- evaluation/negotiation;
- tax control;
- contract/order;
- supply control;
- invoice processing;
- payment;
- accounting;
- reporting, etc.

Fourth is the translation of the observations from the follow-up controls into measures which lead to satisfactory procurement standards.

Conclusion

For several years, the RRV has expressed objections related to the agencies' difficulties in meeting demands relating to the application of commercial principles, and in applying the principles of competition and objectivity in the central government procurement process. There is still much room for improvement in the public procurement field through a more professional management control approach being implemented in the agencies.

MANAGEMENT CONTROLS: A SENIOR EXECUTIVE PERSPECTIVE

by
G.M. Kirby³

Executive Summary

This paper outlines cases from a senior executive's experience in carrying out two different functions in two quite different organisations, both of which were considered by outside authorities to be out of control. Through the use of examples, it shows how it is possible to create an environment in which control can play a positive role, how to identify the factors that permit a reasonable control environment to exist, such as policy definition and corrections to the approach to an administrative activity or operational programme.

It may require considerable resources and effort on the part of management to correct control deficiencies in an organisation, but the returns from such an investment are high, in terms of the effectiveness of programmes, improved decision making, efficiency in the use of resources, public confidence in the organisation, and the pride of its employees.

Some management controls are of a more administrative nature and concern such matters as the protection and management of resources such as personnel, information, and capital assets, both financial and natural. Others are more operational in nature and are associated with programme activities, product and services needs and delivery. Because the nature of organisations differs, their management control needs also differ, as examples from the two organisations show.

It is the responsibility of the most senior managers to define the information they need for control of the enterprise's operations and to assure themselves that management control systems are in place throughout. This assurance is usually provided by an effective internal audit organisation and an adequate system of management reviews. Once again, examples of how this can be achieved are given.

Management is challenging, but it can also be fun. To be in a senior position in an organisation that is proud of the way it does business, one that is perceived by the public as being effective and in which the use of resources is always carefully balanced against the benefits to be realised, provides a great deal of satisfaction.

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1. Introduction

This paper will examine management controls from the perspective of a senior manager. The reasons why the control needs of the most senior managers must be taken into account throughout the organisation will be examined and then illustrated by two examples from the author's personal experience. They are the experiences of the comptroller of an international aid organisation and of the chief operating officer of a real asset holding agency.

Although the focus of the papers in this volume is on the need for management control systems in government, the same needs exist and the same principles apply for state-owned corporations and the private sector. By definition, management requires monitoring activities and analysing the results and feeding them back into operations, so as to keep on track and conform to the requirements of good administrative practice, as recommended in the INTOSAI *Guidelines for Internal Control Standards* (I, para. 72).

2. Management information and management controls

In well-run organisations, the most senior executives can be confident that the procedures and processes necessary to ensure the sound management of the organisation's resources -- finance, personnel, materiel, real assets, and information -- are in place and effective. The resource control processes include internal audit and management reviews that provide reports which either assure the executives that all continues to be well or, if not, permit them to take corrective action. The executives can thus concentrate on strategic and operational planning and the implementation of operations.

The management of operations requires information obtained both from within and from outside of the organisation. Some of this information concerns the use of resources, and some concerns matters such as the delivery of goods and services or changes in the needs of "clients". Management information is an integral part of management control, but not all controls require the provision of information in order to be effective.

In some organisations, resource management procedures and processes are ineffective, and resources are in danger of being (or are being) wasted, misappropriated, or stolen. Such cases require considerable effort on the part of senior executives and others to correct the deficiencies, and this detracts from the attention and energy that can be focused on operations. The potential gains from effective use of resources make corrective efforts worthwhile.

3. Control needs of senior executives

Although all management control systems will have common elements, such as financial, personnel and inventory controls, every enterprise has characteristics that are unique in terms of role, time, operating environment, and priorities. It is this uniqueness that determines some of the control needs of the senior executives. Whether these executives are operating in the private or public sectors, their enterprise's goals and their plans for achieving those goals reflect the environment in which they operate, the priorities that have been established, and the resources at their disposal. Moreover, it is the chief executive who provides direction for all the other managers of the enterprise. To provide that direction, the chief executive must have credible, timely information concerning not only the financial and other standard indicators of interest to all managers, but also information on those factors that are crucial to the well-being of the enterprise at that particular time (I, para. 32).

Thus, the president of a coal mine, the State Secretary of the Ministry of Agriculture, the chief executive of an aerospace company, and the head of a large retail store are all in charge of an enterprise's operations, but the essential information they need to manage it is different because of the specific character of the enterprise; in addition, it also usually changes over time. While for the retail store this information would certainly include sales data, inventory, spoilage, and so on, for the State Secretary it may be parliamentary questions, the status of policy documents under preparation, and key operating information in priority areas such as the implementation of a special agricultural subsidy programme.

It is the primacy of the most senior executives' needs and their changing character which make it essential to design management control systems from the top in an iterative manner. The current and likely future needs of the most senior executives must be identified, an understanding of the means of gathering the necessary information must be developed, and that process, as well as those required for other control systems, must be integrated and provided to the most senior managers for their use. Finally, a process must be established for turning senior management's decisions into action.

The need to identify the needs of senior executives early in the process of establishing control and information systems is important for technical reasons as well. Modern computer systems are very powerful and can manipulate and present many types of information from the same data. But these systems depend on precise definitions of data and their coding within the database. Once the coding block has been established, it is often very difficult to add new terms and new kinds of information to the system.

The demands on senior executives are often such that they have no time to monitor the most common elements of a management control system. Often, they will "manage by exception". That is, they will leave to others the monitoring and control of the routine operations and administration of an enterprise and become involved in such activities only if necessary. What is considered "necessary" may differ with different individuals -- some may want to be involved earlier in a deviation from plan or the appearance of a problem than others.

Most senior executives will be very specific about the information they want to have available for their consideration. These demands are subject to change, since they relate to the areas of vulnerability of the enterprise at a particular point in time or to the priorities of the day.

The control systems imposed by two different managers on the same activity can be very different, but both can be effective. Management styles do not have to be the same -- only the principles do. These are outlined very clearly in the INTOSAI Guidelines.

4. Case 1: The Canadian International Development Agency

The Canadian International Development Agency (CIDA) is the principal organ of the Canadian government for planning and delivering foreign aid. When I joined the Agency in 1982, it was active in about 80 countries, had representatives on the boards of directors of all the regional development banks, supported about 15 multilateral development agencies and about 400 non-governmental organisations, such as CARE, the Red Cross, and World University Services of Canada. At that time, CIDA's budget was about C\$ 2.4 billion a year. There were about 1 200 employees in Ottawa and 400 overseas. The Agency's programme was divided into four parts:

- the bilateral programme, with a budget of about C\$ 1.2 billion and 1 200 active projects in 60 countries;
- the multilateral programme, with a budget totalling about C\$ 800 million, with an emergency aid programme of C\$ 20 million, contributions to about 15 multilateral aid agencies of C\$ 250 million and to the international development banks of C\$ 350 million, a food aid programme of C\$ 120 million and other minor activities for the rest of the budget;
- the special programmes, with a budget of about C\$ 120 million which supported about 400 small and large non-governmental organisations, which ran a facility to promote co-operation between Canadian and third-world businesses, and which generally managed all the aid activities that did not easily fit into the other two programmes;
- the administrative programme, with a budget of about C\$ 150 million covering the salaries and benefits of the employees and all the other administrative costs associated with running the aid programme.

I was the Vice-President and Comptroller of CIDA from 1982 to 1986. I was chief financial and information officer, with a staff of 245 persons, and I also had responsibility for the administrative support of the internal audit function. As Comptroller, I chaired the Contracts Committee of the Agency, which issued about C\$ 260 million worth of contracts a year, sat on the Internal Audit Committee, and was the official point of contact with the central agencies of government that were responsible for the management policies of the ministries. I was also responsible for relationships with the Auditor General of Canada.

My own management control needs were determined both by my functions and by the priorities set for me by the President. In addition, as chief information officer, I was responsible for seeing that the management control and information needs of all the managers in the Agency were satisfied.

When I joined the Agency, several major scandals involving fraud had recently occurred. The Auditor General of Canada had carried out a comprehensive audit and was very critical of the resource controls and procedures of the Agency; year-end expenditures were considered to be haphazard and inefficient; and a major, integrated information system had been defined and was about to be developed. Moreover, the financial staff of the Agency were in disrepute, because they were considered to be unresponsive, inefficient, and generally unsupportive to the operational branches. Parliament had also questioned the fairness of the contract-award process.

At that time, my management experience was quite extensive, but my experience in third-world development was non-existent. I was not responsible for the development programmes, but it was evident that the management control systems had to cover this area, since it presented the greatest potential for loss of control. Thus, my first step was to initiate what I termed a "vulnerability analysis" (I, para. 32). This was a survey of those operations and activities of the Agency whose character made them potential danger spots. These were not only spots at which, through accidental or purposeful actions, resources could be lost, diverted, misused, or misappropriated; the vulnerability analysis also identified points that were potentially politically dangerous. Public servants are usually familiar with these areas -- operations where errors, inaccuracies, or illegal actions do not result in a significant loss of resources but do cause the government embarrassment. Perhaps the allocation of social housing is a good example. If there is a limited supply of social housing and it is allocated to qualified applicants on the basis of favouritism rather than need or seniority, the state loses no resources, but the public's knowledge of this favouritism can be very embarrassing to government.

Before describing a few of the systems that were set up to provide controls on danger spots, it should be pointed out that my chances of success in improving management controls rested not only on my own determination and energy, but also on the support I received from the President and Senior Vice-President of the Agency (I, para. 25). Moreover, the whole Agency was very concerned, and somewhat embarrassed, that the Auditor General had given it such a poor report as a result of a comprehensive audit, and a follow-up audit was expected to start in three years' time (I, para. 80). The Agency staff wanted to do better next time (I, para. 26). Finally, the confidence of the Canadian public in its foreign development agency had been shaken by the revelations of the Auditor General, and the public's willingness to continue to designate CIDA as the manager of a significant part of its taxes could not be taken for granted. If CIDA did not improve its management, it might cease to exist.

This factor of public confidence is very important to any organisation, whether private or public. Good management controls are not evident to the public, but poor controls usually are and result in loss of credibility and thus of confidence in the organisation (I, para. 19).

Project management and the protection of project assets

The bilateral programme area was one of the most vulnerable. As noted, there were 1 200 bilateral projects being managed in about 60 countries. These countries are doubtless among the most corrupt in the world, and CIDA was spending C\$ 1.2 billion annually on them. The projects involved funds to pay for local staff and for work contracted locally, goods for construction, administration and monitoring, including vehicles and equipment of all kinds.

I met with the bilateral vice-presidents -- as a group and individually -- in order to convince them that they were endangering not only their own programmes but the Agency itself if they did not have adequate control systems in place in all their operations, and to offer my assistance (I, para. 25).

With their support, I assigned one of my senior staff and several assistants to each of the four bilateral branches. These persons were physically located at the branches and had instructions to become thoroughly familiar with the branches' projects, countries, and staff. Moreover, they, or a qualified junior (I, para. 31), had to visit each country office at least once a year. The procedure that they were to follow while there was carefully outlined and included a review of the administration of all major projects, the office accounts and procedures, and a few field visits to ensure that what the books listed was reflected in reality (I, paras. 34 and 58). Each visit concluded with a report to the local head of the country office with copies to me and the branch vice-president (I, para. 59). Reports outlining the steps taken to correct any problems identified as a result of these visits had to be sent by the field office to headquarters, and subsequent visits verified that these steps had been taken.

The need for this follow-up activity can be inferred from the INTOSAI Guidelines, but its importance should be emphasized. Just as the announced return of the Auditor General was an incentive for the Agency to improve its management controls, so the return of internal auditors, or the follow-up activities of a manager can ensure that action to correct a lack of management control takes place promptly and effectively.

Throughout these visits, my staff and I stayed in very close touch with the internal audit staff, who were asked to take over when it appeared that illegal activities might be taking place (I, para. 78).

Also as a result of my meetings with the bilateral vice-presidents, we initiated a special course for all project officers on financial management. This was designed to ensure that those running projects became aware of where their new projects might be vulnerable to abuse or mismanagement and to show them how to make provision for the staff to put in place procedures to ensure that their project resources were safeguarded. In other words, we ensured that the managers of projects were adequately trained so that they could take responsibility for their own management controls (I, paras. 58 and 72). Moreover, with the agreement of the Human Resources Branch, my staff were involved in the hiring of project staff whose duties would involve resource management (I, para. 31). Once this training and the new hiring practices started to take effect, my staff could check procedures and controls and no longer had to work at the transaction level.

Internal audit, which had an extensive annual audit plan, reported directly to the President (I, para. 54). Although "separation of duties" generally refers to reducing risk at key points in important transactions, this same separation is important in controls. The chief operating officer of an organisation needs an independent and objective monitor of controls (I, paras. 13-15 and 78), as well as assurance that even the most senior officers are carrying out their duties, including their control duties. An independent and objective internal audit organisation is one of the most common and effective ways of achieving this. Its independence and objectivity did not, however, affect the potential for fruitful collaboration between internal audit and my staff.

Internal audit staff were effective and thorough, but, with CIDA headquarters and 60 country offices to cover, they could only travel to each country about once every five years. Our close co-operation allowed them to schedule extra visits when it appeared necessary (I, para. 74). The involvement of auditors in the strengthening of project management went further as we gained experience in following up suspected criminal activities. We sent the internal audit staff on special courses to learn to recognise illegal activities and, in addition, began to involve trained forensic auditors in cases such as suspected fraud.

Our purpose was not only to detect illegal activities but to prevent further occurrences. It is amazing how quickly illegal practices stop when those involved, or tempted to become involved, sense that the chances of getting caught are quite high [I, para. 60 (3)].

Year-end expenditure management

The Canadian government publicly announced a goal of a foreign aid budget of 0.5 per cent of GNP. The Canadian economy was growing while I was at the Agency, and each year our budget got larger, not because we asked for an increase, but because the national economy grew. When the economy grew more quickly than expected, we would sometimes receive a sudden increase in budget in mid-year. For a comptroller and his staff, it is a mixed blessing to have more money than expected.

There was a further complicating factor, and that was the uncertainty of project schedules. Each year the budget for each of the 1 200 bilateral projects was estimated and expenditures for each were related to milestones on the relevant project schedule -- good project management control procedures in any organisation (I, para. 32). The difficulty was that sometimes, for very valid reasons, the schedule could not be followed and thus the money went unspent. At the beginning of the year, it was impossible to tell which project would be behind schedule, but it was certainly possible, from past experience, to say that some would be. Thus, at the beginning of the year, we knew that a significant amount of the funds for bilateral projects would be unspent at the end of that year. In the Canadian government, with minor exceptions, any funds unspent at budget year-end "lapsed", that is, they ceased to be available for use.

Our first task was to determine from past experience how much money usually remained unspent for the purposes for which it was originally intended. Historical analysis showed that this was between 8 and 12 per cent, but at least 8 per cent, which, at the time I was there, was equivalent to C\$ 96 million!

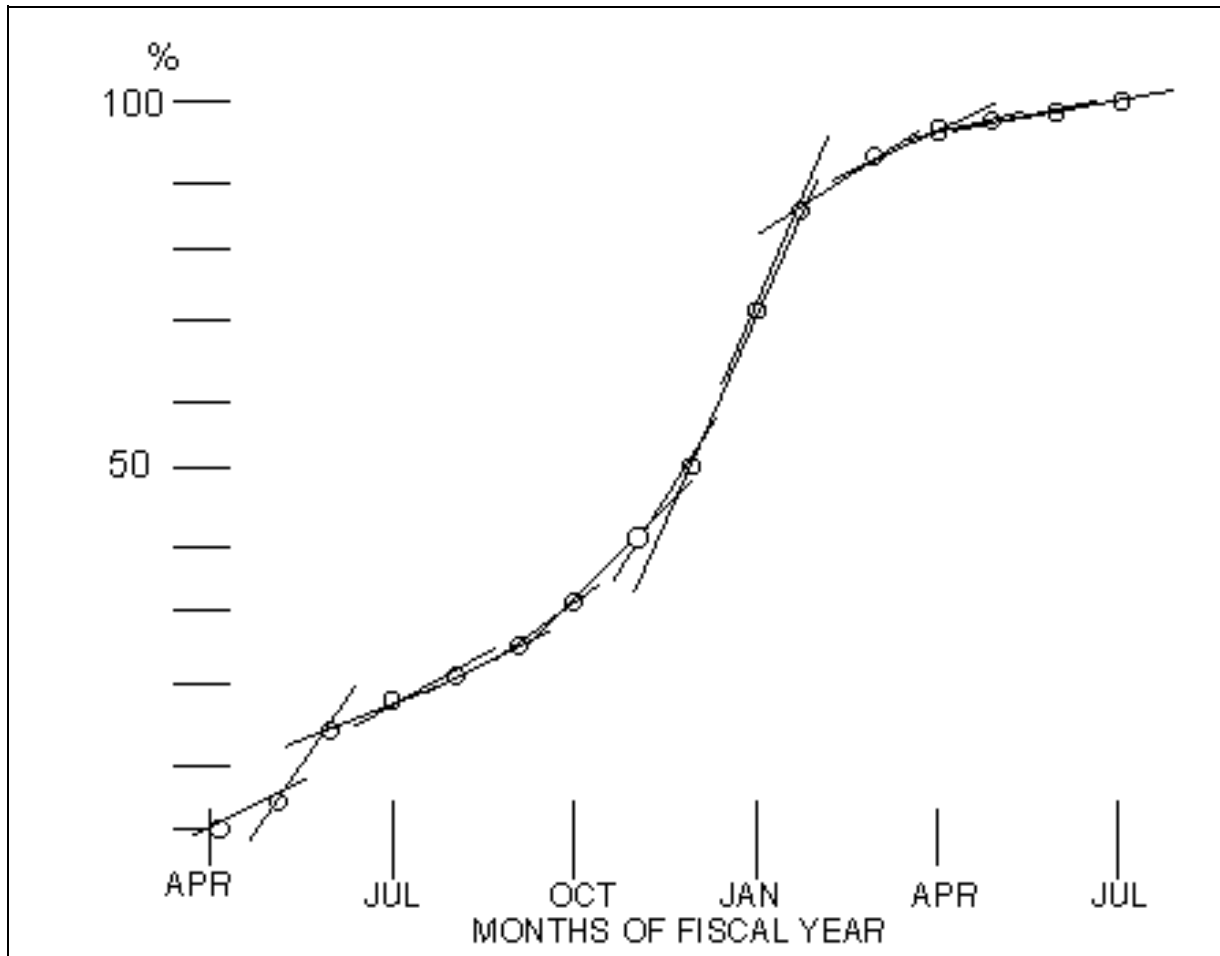
To correct this problem, our first step was to convince the bilateral staff that there was solid logic behind steps to get authority to over-commit funds to the extent of 8 per cent of the bilateral budget, that is, to initiate additional projects with a value equivalent to 8 per cent of the budget. It is obvious that if every project remained on schedule we would "break the bank", but, statistically, the chance that this would happen, with 1 200 projects involved, was minute. The staff had difficulty in understanding the statistical basis for this, but once they were convinced, we obtained the necessary authority from the central agencies to initiate additional bilateral projects worth the equivalent of 8 per cent of the budget (I, para. 68).

We then used the same historical project data to establish a typical disbursement pattern for a typical financial year. This was done by taking the data for the previous three years and averaging it so that year-to-year variations were minimised. The result looked something like Figure 1.

The financial year (1 April to 31 March) got off to a fairly slow start as the new project budgets became available. Major budgetary commitments were made by contracting for goods and services, but disbursements were slow because most orders required several months before delivery. There was further slow-down as the summer holiday season started and staff interest in the projects was overcome by family interest in taking full advantage of the school holidays and good weather. (The bilateral staff often travelled for three-week stretches for annual total periods away from headquarters of up to six months.)

The disbursements really got under way in September as major contract deliveries were made. At this point in the financial year, project managers would watch the project schedules and the achievement of milestones carefully, in order to identify project delays early and inform more senior managers that funds were available for disbursement elsewhere (I, para. 39). Thus, disbursements tailed off as the year-end approached and reallocation occurred and took effect. Canadian government financial regulations allowed the payment of invoices for a limited period after the end of the year as long as the goods or services were delivered prior to the end of the year; thus, payments continued into June of the following financial year.

Figure 1. Disbursement profile 1, bilateral programme



There was a legitimate need to have some efficient means of expending as much of our budgets as possible. Our minister considered the international undertaking to expend 0.5 per cent of GNP important. There was an equally legitimate reason not to spend more than our budget; this was that it would contravene the Financial Administration Act (I, para. 3). Thus, we needed to have very accurate information about our disbursements.

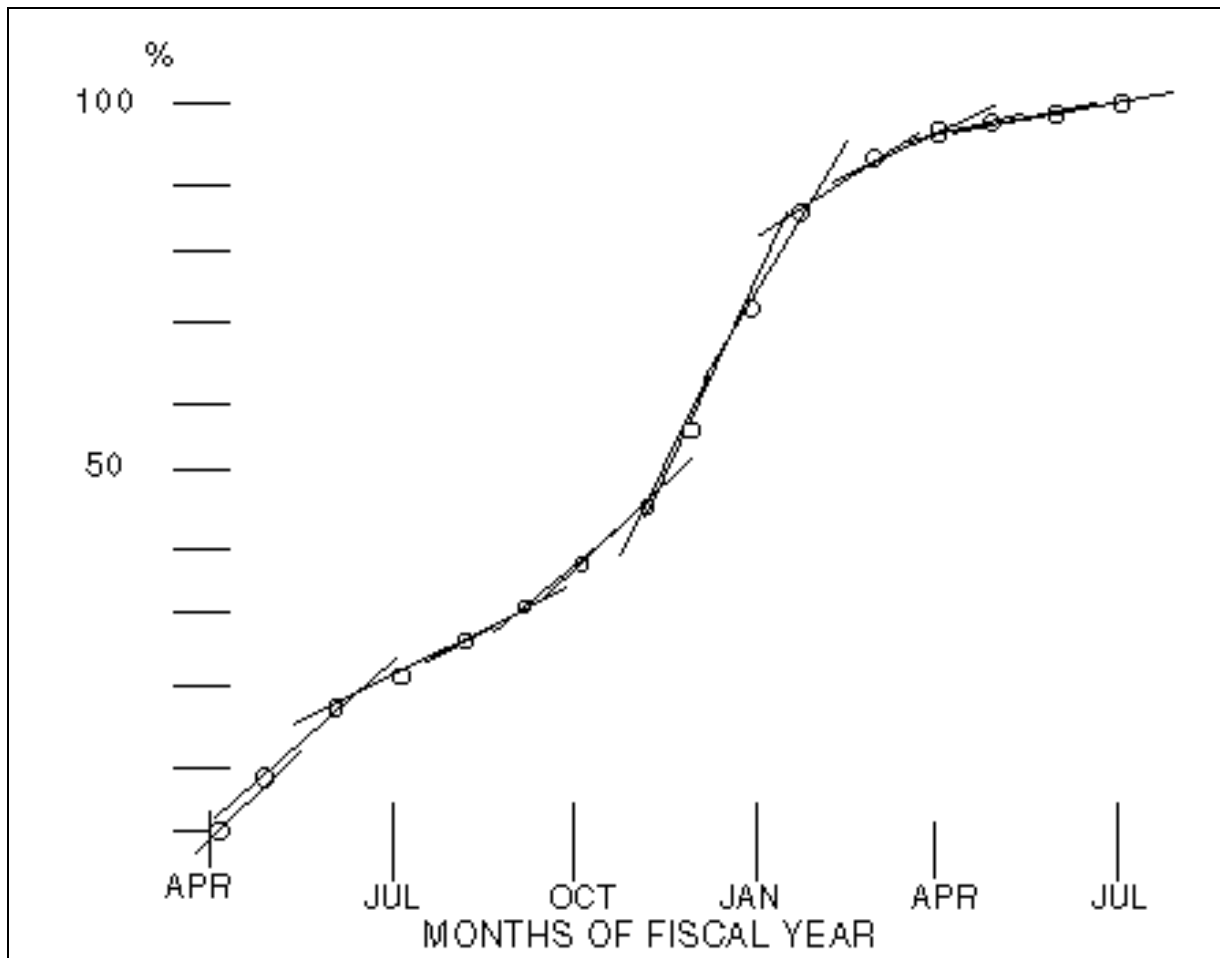
Correcting the lack of control over year-end disbursements required changing the entire approach to budgetary management (I, para. 73). Budgetary commitments had to be made earlier, over-commitment of budgetary funds had to be permitted, and earlier warning was needed of deviation from the "ideal" disbursement profile. After those steps were taken and some experience was gained in implementing the new practices, a new disbursement profile was achieved (see Figure 2).

We had not removed all the variations but the rate of disbursement was more consistent and was predictable and controllable. The management controls that we established to monitor disbursements allowed us, on average, to end the year with between C\$ 800 000 and C\$ 2 million of our budget unspent during the time I was there. That represented about 0.05 per cent of our budget.

In part, our capacity to provide this close control and management was due to the fact that financial data was entered into our new accounting system directly by those responsible for transactions, thereby ensuring the timeliness and accuracy of our information at all times (I, para. 1).

We not only developed the profile for the bilateral programme as a whole but also for each of the four bilateral branches. Our monthly reports, which were analyses available six days after the end of the month, were more sharply focused and provided senior managers with current information on trends and deviations from plan (I, para. 39).

Figure 2. Disbursement profile 2, bilateral programme



A typical report for the project funds of a bilateral branch would provide:

- actual and planned disbursement of funds and balance to be disbursed;
- actual and planned commitment of funds and balance to be committed;
- a comparison of each of the above with performance in the previous year;

- the reasons for any deviations from plan, if known;
- recommendations for corrective action.

Other information on travel and salaries, etc., was also provided and analyzed.

The same information was provided graphically and in written form for the bilateral programme as a whole and for each of the other programmes of the Agency. The administrative programme budget report contained many sub-entries for such matters as travel, hospitality, salaries, and informatics. Our monthly report ran to about 30 pages, the first page of which was a summary of significant deviations from plan and a reference to where details could be found. The President and all other staff were therefore aware, very shortly after the end of the month, of the financial status of the Agency. They could delve into as much detail as they wished and were in a position to make decisions on the changes necessary to achieve the operational plan (I, para. 19).

Contracting for goods and services

The contractual process of the Agency was overseen by a committee of vice-presidents who not only were responsible for the entire process but also reviewed all requests for proposals before they could be issued (I, para. 39). A request for proposals was an invitation to all interested suppliers, or a selected group of them, to submit a proposal to the Agency on how and at what cost they proposed meet a specific need -- whether for the provision of goods or services.

The main ingredients of the contractual process were laid down in a manual issued by the Treasury Board of Canada, which is a committee of ministers and forms part of the Cabinet Committee system of the Canadian government. This contractual process was monitored by part of the Secretariat to the Treasury Board, but there was a fair degree of discretion for the implementation of the process (I, para. 68).

The Agency was criticised for having a system that was not well understood; being biased in favour of large, experienced companies; having a preference for companies whose headquarters were geographically close to CIDA's headquarters; taking too long to get a contract approved and issued; and for being biased towards some suppliers through favouritism on the part of the project officers. A few months of experience on the committee convinced me that the criticism was justified.

We started corrective action by redefining the method of registration on our supplier lists and of submitting proposals. We then prepared a manual that we sent out to all the individuals and companies on our lists and sent a group across Canada to give presentations on how the forms should be filled in and how the computerised selection system worked (I, para. 45). Demonstration computer searches allowed the participants at the presentations to see the system in operation and to understand the logic of searches. Explanations of the process used to evaluate proposals after they had been received were also given. This helped potential suppliers understand how best to specify their areas of interest and their experience and how to submit proposals with a better chance of success.

Our objective at this time was to establish, document and make known a procurement process that was simple, transparent, and consistent. We wanted to operate a process in which the users, whether they were suppliers or Agency project officers, could have confidence (I, para. 20). We knew that the system's built-in controls would then allow us to concentrate on ensuring achievement of our other objectives. The basic system needs to be functioning before major investments in time or money are made to try to correct its operation.

In parallel with revising and "cleaning up" the supplier databases, we introduced a revised request form for the initiation of demands for contracts for use by our staff. Previously, the different branches had different processes, and each had its own form and its own idea of what information was needed. We also placed very stringent limits on the kinds of "emergency" requests that would be accepted by the committee and required all committee documentation to be received by its members at least three days in advance of meetings.

We proposed, and obtained the President's agreement on, targets for the number of contracts that should be issued to small firms and to inexperienced firms (I, para. 32).

We set up a database to allow us to monitor trends in the geographical distribution of contracts and a system to monitor the time taken from the point at which a decision to request a contract was taken until the contract was actually issued (I, para. 39).

We revised the delegations to staff to approve requests without review by the committee and the form of the report that was to be presented to the committee with a listing of all the contracts so approved (I, para. 22).

We set up a system to inform us when companies or individuals received more than a certain total value of contracts or a certain number of contracts. It also informed us about the number and type of complaints about awards received and about approval of transactions that were outside the limit delegated to us by the Treasury Board and required the latter's approval before matters could proceed (I, para. 68).

The committee met weekly and reviewed the applications from our staff for authority to issue requests for proposals. The meeting documentation also included the control information and statistics for the week, and quarterly reports were issued outlining trends and identifying potential trouble spots (I, para. 39). Thus, finally, our management control system for the contract function was up and running.

Information management

Managing several thousand projects, running simultaneously and with varying performance as compared to plan, can be accomplished manually. Managing related expenditures and their effect on the overall accounts and budgets is also possible without the aid of computer systems, but the number of personnel required to carry out the functions and the opportunities for error increase tremendously.

When I arrived, CIDA had some rudimentary automated systems. Their inadequacies and the potential for improvement had been recognised, and a major project to establish a major relational database system to assist in the management of all facets of the agency's operations had been initiated. Efforts to develop automated systems in the Canadian government had often failed in the past, and our staff had taken careful note of the lessons learned. These included, in particular, not trying to do too much.

As a result, some early decisions were made to restrict the scope and definition of the system. It was decided, for instance, not to develop a module for senior management -- a wrong decision as it turned out -- and to develop the system by modules, the first of which would be for financial and project management.

The development of the financial management module was complex, and it was quite difficult to bring it to the point where data could be entered. Yet, developing the module was far less difficult than its implementation. It had to be able to relate projects to the financial accounting system, since, in future, both systems were to use the same data for different purposes. However, there were virtually no links

between the previous rudimentary systems -- one of which, for instance, reported project progress against milestones, while the other reported financial expenditures against contracts.

It was essential to retain audit trails between the previous and new financial systems. The old project management systems contained basic budgetary data, but it formed few links between milestones and budgets. Initially, combining both these systems in a relational database was a disaster. The problem was not the classic "garbage in, garbage out", as each previous system was fairly effective. However, they did not relate to each other. The project managers knew at which stage their projects were but did not relate them to the Agency's budgetary system, while the financial administration knew the state of contracts and commitments but were unable to relate these to projects. The situation had never become a serious problem because there was always enough spare money to cover any deficiencies and year-end management concerned budget and not project accomplishments.

The solution to the lack of linkages required reviewing every project in the Agency's portfolio, establishing its status and relationship to the original budget, creating new linkages between milestones and budgets, and entering all this new data in the database, while at the same time protecting the integrity of the original accounts and budgets. This required close to a year's work and caused a major delay in final acceptance of the new system. However, without this effort, our work on year-end expenditure management would not have been possible.

Along the way, we had to deal with definitions, custody and security of data, and a host of other matters which require close management if the final system is to maintain its integrity and credibility.

Effects of the decision not to proceed with the system module for meeting the information needs of senior management were felt not long after the new system was up and running quite successfully. The Agency President asked for information on the number of projects that affected, in any way, women in the third world. Since it had been no one's responsibility to ask senior managers what kinds of information they wanted to have available, and since no one had anticipated the request, the information had neither been allowed for in the data-coding system nor gathered as each project's data was reviewed and entered into the new system. Because the President saw this as a priority area, every project had to be reviewed once again, a new coding block had to be established, and additional data had to be entered, verified, and analyzed. It was possible to carry out this exercise in parallel with the operation of the new system, but it cost several hundred thousand dollars to create this new category.

In 1984, the Auditor General of Canada returned to the Agency to carry out his second comprehensive audit. We knew that much remained to be done to complete our management improvements but we were very proud of what we had already accomplished. In discussing the work programme for this audit, we were able to convince the Auditor General's Office that they should not only report what was left to do -- their official task -- but give us credit for what we had already accomplished. Their report, which was issued in 1985, gave a balanced view of our deficiencies and accomplishments.

5. Case 2: The National Capital Commission

The National Capital Commission administers most of the federal real assets in the National Capital Region that are not used by the administration or the government for day-to-day operations. The National Capital Region spans the borders of the provinces of Ontario and Quebec and includes the cities of Ottawa and Hull, as well as a large area around those two cities.

When I was there, the Commission's assets consisted of about 800 buildings, including five official residences, such as those of the Governor General and the Prime Minister, and 100 kilometres of parkways, 250 kilometres of asphalt recreational trails, a self-contained natural park of 40 000 hectares, most of which was wild, 17 000 hectares of suburban and urban parks and numerous bridges, retaining walls, railings and so on. The Commission also ran camping grounds, beaches, environmental demonstration centres, ski trails, golf courses and similar activities on its lands. The Commission's responsibilities included authority to manage land use and exterior design of all federal lands and buildings, including those of the administration, urban planning, long-term planning for the capital, and the management of national festivals in the National Capital Region.

The Commission had a staff that peaked at 1 500, but varied seasonally. Its budget, when I joined it in 1986, was C\$ 130 million, of which C\$ 30 million were revenues from leases, permits, entry fees, etc. Budget reductions reduced our total budget by about 25 per cent over the next four years.

I was the Chief Operating Officer of the Commission from 1986 to 1990. My duties were to manage all its operations. I reported to the Chairman, a dynamic individual who had been in place about two years, and who fully supported the need for management improvements and took responsibility for managing external relations and the long-term vision of the Capital (I, para. 25).

The Commission was viewed as arrogant, unresponsive, and inefficient. My predecessor had been found guilty of fraud, the budgetary reductions that were being imposed required reorienting the Commission from being an institution that was building the Capital to one that maintained the existing fabric, and the staff were demoralised.

Management control for the chief operating officer

My arrival in an organisation trying to recover from the effects of a predecessor who had committed fraud required a major change in the organisation's perception of my position's functions and priorities. Not only did the staff have to understand that a "new broom" was going to clean up practices that had permitted fraud, but also that someone was going to take a great deal of interest in how they did their job (I, paras. 29 and 30). This meant obtaining information on current activities and necessitated major revisions to the control systems as well as a redefinition of the information to be provided to me for control (I, para. 39).

To achieve the necessary new relationship, I decided I would need to "micro-manage" at the start of my tenure. That is, I would demand quite detailed information on all significant activities within the Commission rather than leave the details to others and concentrate on the exceptions.

I met with the senior staff responsible for functions such as finance, vehicle use, inventory, contracts, personnel, planning, festival organisation, real estate, and natural resource management and agreed with them the steps they would take to get their areas of responsibility in order. We also defined which indicators would be used to monitor progress, established dates for the achievement of milestones, and decided on the expected "outputs" of their efforts (I, para. 32).

We hired a number of second-year computer science students who were doing their practicum, or work term between academic terms. (Students are much more imaginative and considerably cheaper than experienced computer professionals.) One was given the task of creating a "BF", or "bring forward", system for me. This is a manual or automated system to record the fact that a certain document or action should be reconsidered at a specific future date and reminds the user on that date (I, para. 60). In my BF system, the first thing that appeared on my computer screen when I turned it on in the morning was a list of the

actions or documents to be looked into again that day. The system allowed me to copy my notes on the subject and to mail them electronically to the person responsible for the subject and ask them for a report. They could either reply by electronic mail or send me the necessary report, document, or item. I could then update the BF and set a new date for the item to reappear on my screen. At one point, I had 140 different subjects on the BF system. Some were recycled for reconsideration every few weeks, some quarterly, and some annually. The subjects were varied: a financial report, roof repairs on the Prime Minister's residence, the planning for a major festival.

My senior staff soon became used to the system, and when I told them I was putting a subject on my BF system and we had agreed on a date, they would put it on theirs with an earlier date to remind themselves that I was going to ask for a report.

This BF system, combined with conventional reports on financial or personnel matters, for example, constituted my management control system. It was more detailed than that of many senior executives but necessary under the circumstances.

Real asset management

The move from "building" to "maintaining" our assets was complicated by the fact that the necessary experience was lacking (I, para. 49). In the past, repairs had been undertaken only when they were seen to be necessary; they were not anticipated. Moreover, when repairs were necessary, there was money to pay for them. Owing to budgetary reductions, this was no longer the case. Finally, we knew that much of the built infrastructure had been constructed at about the same time and that much of it was reaching the point where it would need major repairs. The management of our real asset portfolio was very haphazard.

Once again, it was not possible to implement a control system until a sound basis for management had been established and the database of our asset holdings was accurate, consistent, and complete. This was achieved by establishing a task force of about 15 persons, including road, structure, park, and land-use specialists, who spent the next 18 months visiting each asset, assessing its condition, and describing their findings in detail in electronic form. Simultaneously, a small group studied the literature and consulted experts to determine the optimal time for maintenance for each type of asset and the financial consequences of not undertaking the maintenance at that time. This information was also included in the database (I, para. 40). Finally, the results of the task force's work were transformed into a ten-year maintenance investment strategy. We then had a real asset database and a maintenance approach that incorporated the necessary control systems.

Each year thereafter, our annual plan and budget included the relevant projects from our maintenance plan. When projects were delayed or funds were short, the most urgent new projects could be begun and the plan adjusted to take account of the change. During the year, reports were sent to the Commission and to senior staff concerning the progress of works undertaken that year and providing recommendations when that work was not proceeding according to schedule (I, para. 38). (As in CIDA, we initiated projects of slightly greater value than our budget to take account of the fact that some delays would occur.) Each year, every asset would be visited by an expert to ensure that its condition had not changed more than anticipated. Our management system for real assets was now working.

Lease revenues

Many of the Commission's 800 buildings were leased as private dwellings, retail and commercial establishments, storage warehouses, and farms. A reasonable database of leases, rental values, and receipts existed (I, para. 49), but the management of the leases caused considerable difficulty.

Reports of arrears were not routinely available, and actions to correct arrears were not based on any policy. Once again, the control systems had to await resolution of other management problems. Our first step was to prepare a policy document dealing with such matters as the actions to be taken when rents were in arrears, renovations that were to be undertaken when a new tenant moved in, and standards to be employed for renovations to different classes of buildings (I, para. 40). Once approved, all tenants were made aware of the policies and, as leases came due, new terms consistent with the new policies were inserted. Moreover, rents were compared with those in the private sector and gradually adjusted to match them.

Monthly reports became available on receipts, arrears of various periods, expenditures on renovations, leases coming due, and vacancies. Adjustments were made to some of the policies when this seemed necessary. The monthly reports included a summary of problem areas and recommendations for corrective action.

Management of the natural habitat

The ownership of very large stretches of park lands and forests involved responsibilities for effective management of fauna and flora. Sometimes the two became unbalanced and actions had to be taken. Two illustrations come to mind.

The natural park of the Commission was mostly wild and not easily accessible. Management of the forest resources originally required surveying on foot. This is a time-consuming and not very effective means of monitoring. Air surveys are expensive and require the survey aircraft to have specialised equipment. For instance, the effects of pollution and drought can best be seen with infrared photography. We began using satellite photographs for the control and management of the forests. We obtained colour and infrared satellite photos for the five previous years and instituted a procedure to obtain a new set each year thereafter. Changes and trends were now reasonably easy to see and corrective action could be undertaken.

The natural park was a favourite location for beavers, and, although the beaver is Canada's national animal, it becomes a pest to those managing forest resources when populations become too large. Not only does each beaver cut down a large number of trees, but beaver dams flood large areas and kill all the trees within the flooded area. Beavers are very effective dam builders and quickly detect leaks and repair them. However, the dams sometimes break, occasionally with serious consequences for the Commission's infrastructure and that of others. Our roads were quite often washed out because of flooding from a broken dam.

Although the satellite photos were a great help in spotting new dams, it was often too late to save the flooded trees. Frequent ground surveys of vulnerable areas usually identified fresh dam building, and the beavers could be trapped and removed from the park area. It was somewhat more difficult to know what to do in when the beavers raised the height of their dam, thereby flooding more land. We did not want to destroy every dam, only to restrict the total area flooded and the total population of beavers. One of our conservation staff found the solution. A 10 cm plastic drain pipe about 7 m long was embedded in the dam, perpendicular to its wall and with the end within the dammed area extending about 4 m back from the dam wall and slanting upwards so that the end just reached the surface of the water. If the beavers tried

to increase the height of the dam, it would "leak" and, try as they might, they were unable to stop the leaking. They very soon tired of trying to increase the height and migrated elsewhere. Controls can even be applied to the management of beavers!

Correspondence

The Commission used to receive about 100 letters a day from the public of the region, ministers, other governmental organisations, and so on, on a multitude of subjects ranging from wildlife to new budgetary allocations. When I arrived, a central secretariat ensured that all mail was sent to the appropriate staff member and then reviewed letters coming back for signature by the Chairman or myself to ensure they were in the proper format, contained the necessary information, and were ready for signature. There was no system for tracking letters, and some were either never answered or were answered only after a very long delay.

Many correspondence tracking systems are available on the market, and a suitable one was purchased and installed. Policies concerning turnaround time, the kinds of letters various levels of staff could sign, and actions that should be taken when, for instance, a letter could not be answered within the required time were established, and the new system was implemented. Reminders were sent to staff when replies were late, and monthly reports provided statistics on each branch's performance in meeting their correspondence responsibilities.

Once again, management controls had to await the establishment of a suitable database and definition of the relevant policies.

6. Conclusion

There is no such thing as management without controls. Every facet of an organisation's activities can be controlled, and it is the responsibility of managers to judge the extent and form of such controls. Organisations with long experience of good management and appropriate controls may be able to depend on a less intensive set of checks and balances than one that is recovering from a bout of bad management. However, even the most solid and well-run organisations will have systems to reassure managers that all continues to be well, and all systems are working as designed.

It is very rewarding to join an organisation with inadequate management and to participate in correcting the faults and watching performance improve. The returns on investments in good management are very high and are realised not only in financial terms but also in the pride of the employees and the respect accorded them.

**MANAGEMENT CONTROLS: THE ROLE OF CENTRAL AGENCIES
(Canada)**

by
James Q. McCrindell⁴

Executive Summary

This paper focuses on the role of central agencies in establishing a framework for management control in government ministries, mainly from the Canadian perspective. While some countries have similar practices, others use different means to develop and promulgate an effective management control framework, for example, by using their supreme audit institutions or by detailed prescriptions in the law.

Canada's central agencies' leadership responsibility for management control is in keeping with traditional roles dating back some 125 years, since shortly after Canada became a separate country. As well as providing leadership for fiscal management and management of expenditures and human resources, these agencies advise the Cabinet through the Prime Minister and act on his behalf to manage the public service; this latter role is distinct from the management of government programmes, which is, of course, the responsibility of ministers.

In addition to the central agencies such as the Treasury Board, reporting to the Canadian government, there are central agencies which report directly to the legislature. Principal among these are the Office of the Auditor General, which is Canada's supreme audit institution, and the Public Service Commission, which exists to protect the merit principle in staffing, that is, to ensure that there is no discrimination in the recruitment and promotion of government employees.

While Canada's central agencies have not developed an actual framework for management control, most of the characteristics of management control contained in the INTOSAI *Guidelines for Internal Control Standards* are part of Canada's legislation and the policies of its central agencies. Recent public sector reforms in Canada concerning quality services, accountability, and greater use of information technology are also in harmony with INTOSAI principles.

Canada's Auditor General has significant influence on management controls, although he has no formal responsibility for their development and implementation. Through his reports to the legislature and his independent research on best practices in Canada and around the world, the Auditor General provides central agencies and individual ministries valuable support for improving control.

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While the Auditor General believes that Canada's basic internal controls are good and is generally supportive of recent reforms, he has publicly expressed concern about inadequate attention on the part of central agencies to management controls, particularly with respect to what he perceives as inadequate means of accountability for the increased delegation of responsibilities to ministries.

1. Framework for management controls in Canada

Authority for management controls

The Parliament (legislature) is the highest level of authority for management controls in the Canadian government. It is the supreme legislative authority, and any legislative powers it delegates are subordinate in nature. Subject only to the Constitution and the Charter of Rights and Freedoms, Parliament is empowered to enact any laws it chooses. It has, however, delegated extensive authority to the executive. This allows the government in power considerable latitude in carrying out its responsibilities.

The Financial Administration Act (FAA) is the legislative basis for management controls. This Act includes a number of control standards, but, perhaps most important, it requires by law a permanent committee of government ministers, called the Treasury Board (TB), which is responsible for all matters related to the public service administration. Separate from the Ministry of Finance but working in close daily collaboration, the TB is responsible for all aspects of the Expenditure Budget.

This legislative requirement is unusual, as the establishment of committees of ministers -- known as cabinet committees -- is ordinarily the prerogative of the Prime Minister, not the legislature. However, it reflects a Canadian tradition that public service administration, expenditures and related controls must be a central concern of government. Indeed, the legislative requirement was first introduced over 125 years ago, not long after Canada was constituted as a separate country.

The FAA also requires that a senior minister of the government be appointed as the President of the Treasury Board and that the board comprise four other ministers. The Minister of Finance is recognised as an *ex officio* member of the board because of the impact of his or her recommendations and decisions on the government's internal planning and budgetary process. These are strong conventions encouraging ministers on the Treasury Board to set aside their own portfolio interests in favour of collective governmental interests during TB deliberations.

Development and promulgation of management controls

With the exception of some broadly applicable controls contained in the Financial Administration Act, most legislated controls are in separate Acts related to specific government programmes, such as those for the collection of taxes and duties. The majority of management controls that make up the government-wide framework are not legislated. These controls are developed and promulgated in the form of TB policies and guidelines.

TB policies have the status of regulations backed by legislation whereas guidelines provide guidance or examples of best practices. While these guidelines are not mandatory, they are often used by auditors as standards. However, an auditor would not normally criticise an alternative to a guideline so long as it was equally efficient and cost-effective.

TB policies and guidelines are promulgated through a *Treasury Board Manual* for ministries. TBS also issues a *Manager's Deskbook* that highlights, in non-technical language, the most important management controls that a manager should be familiar with. The information contained in these and similar TB documents is now available in electronic form through government and ministerial information networks. It is also available within government and for public use on a compact disc.

Role of central agencies

As well as requiring a President of the Treasury Board, the FAA also establishes the post of Secretary of the Treasury Board with the rank and all the powers of the deputy head of a ministry, that is, the most senior public servant in a ministry. This has led to the establishment of a central agency known as the Treasury Board Secretariat (TBS), which is the administrative arm of the Treasury Board Cabinet Committee for developing and maintaining TB management control framework for government ministries. This is in keeping with INTOSAI's suggestion that this responsibility could be given to a central organisation with authority across various governmental organisations (I, para. 64).

While Canada's Auditor General (AG) has no formal authority or responsibility for management controls, he has considerable influence over their development and promulgation. This is because, in addition to assessing, on behalf of the legislature, the adequacy of management controls and reporting on any deficiencies or opportunities for improvement, he or she does extensive research on improved management controls in Canada and abroad and publishes the results in periodic reports to the legislature. These published research studies and the interest they provoke in committees of the legislature -- primarily the Public Accounts Committee -- serve as a stimulus to the Treasury Board to improve its framework for management controls.

The Public Service Commission, an independent agency reporting to Parliament, regulates the processes of staffing and promotion in the public service. Management control features are built into its operations and include sanctions and audit requirements.

Comparison with INTOSAI Guidelines

The INTOSAI standards are not systematically incorporated into a management control framework in Canada. However, TB does have, in effect, a number of separate sub-frameworks for each functional area of management. For instance, it has reasonably coherent direction and guidance for financial management (financial accounting, controls, and reporting), expenditure management (budgeting and performance reporting), procurement management, risk management, human resource management, and so on. It also has similar functional frameworks for internal audit and programme evaluation.

In addition, the Secretary of the Treasury Board has been endeavouring to encourage improved understanding of management's responsibility for control through the issuance of new guidance on the comptrollership function in government organisations, which is described as the essential, integrated business processes that must be in place in any organisation to:

- manage financial risks;
- understand the financial implications of decisions before they are taken;
- properly track and account for the financial transactions and operating results of all financial decisions;
- protect against fraud, financial negligence, violation of financial rules and principles, and losses of assets.

Monitoring and evaluating management control systems

The most senior public servant in each ministry generally holds the title of deputy head (DH). The DH is accountable to the responsible minister for the day-to-day management of the ministry, the implementation of the minister's priorities, and the quality of the policy advice provided to the minister. In addition, the DH is accountable to the Prime Minister for his overall good management performance, which is assessed annually on the basis of TB criteria. While different terminology is used, some of these criteria cover areas similar to those in INTOSAI's management control standards. Advice to the Prime Minister on the managerial performance of each DH is provided by central agencies.

As part of his or her management control responsibilities, the DH is required to sign each year with his or her senior financial officer a Letter of Representation to the Treasury Board and the Auditor General certifying the accuracy and reliability of the ministry's recorded financial results for the year just ended. Each of these certified letters is used by TBS to prepare the government's annual financial report and by the Auditor General to audit this report. These annual financial reports contain financial statements for which the Auditor General provides an official audit opinion as to whether they represent fairly the government's financial position.

Each ministry also has its own internal audit and evaluation groups which normally report directly to the DH or to an audit committee chaired by the DH. However, their reports are considered public documents and are therefore available to the legislature and the public at large.

Working under TB standards, these groups are responsible for carrying out independent reviews much like those of the Auditor General, except that their reports are prepared as a service to top management rather than for the legislature.

In addition to the monitoring and evaluation activities carried out by ministries and the Auditor General, the government occasionally commissions independent reviews, either through the Treasury Board or through special commissions of experts from outside of government. Such reports are given considerable attention by the media and the parliamentary opposition, as well as by educational institutions and other interested parties, and serve as a point of reference and debate for many years after they are published. An example of the latter was a Royal Commission on Financial Management and Accountability, which issued a public report making extensive recommendations for improved management and control by the government.

Resources, skills, and training for implementing management control systems

When TBS staff review the expenditure plans of ministries, they endeavour to ensure that any reallocations or budget cuts will not impair the ability of ministries to maintain adequate management controls. For example, they may not recommend approval of the discontinuance of an administrative step if they think it will result in unacceptable control risks. An example was a ministry's request to have salary cheques for employees distributed by its personnel staff rather than its financial staff. These cheques, which are prepared by the Receiver General (the Canadian government's centralized Payments Office), are sent to ministry financial officers for distribution. While this request would have saved some administrative time and overhead, TBS did not accept it, because it would have contravened the basic control standard of separation of duties (I, para. 55), as the personnel staff who prepared the payroll information would have had control of the cheques written on the basis of their input.

TBS establishes professional standards for those who perform accounting and financial control functions. Its executives participate on the promotion and recruitment boards which assess the technical competence of all candidates for senior financial, audit, and evaluation appointments throughout the government.

TBS also plays a leadership role in the government's professional recruitment from universities and in development programmes (training and redeployment) for financial officers, internal auditors, and programme evaluation staff. In addition, it conducts training courses for operational managers in a number of functional areas, such as finance, risk, and project management. These activities are consistent with INTOSAI's general standard for ensuring the integrity and competence of those responsible for management controls (I, para. 28).

2. General responsibilities of central agencies

This section discusses briefly the responsibilities of central agencies, mainly from a Canadian perspective. It is important to recognise that the scope and power of central agencies depends on various factors in a particular country, such as the division of powers between the legislature and the executive, and among the national, state, and municipal governments.

If there is limited delegation by the legislature to the executive and most of the controls emanate from laws and regulations made by the legislature there is less need for strong central agencies. The legislature might also decide that the direction and monitoring of management control can be better carried out by an independent body, like the Supreme Audit Institution (SAI), which reports to it directly.

Because the Canadian tradition delegates substantial discretion to the executive the government needs central agencies to enable it to carry out effectively its "corporate" role for the totality of government operations. This is also consistent with a Canadian convention that ministers are responsible individually for their ministries and collectively, under the Prime Minister, for the management performance of the whole government.

A particularly significant objective of central agencies in Canada is to foster institutional values or ways of operating that must be understood and observed by all public service managers and employees, regardless of the nature of their programmes. All public servants in Canada are trained to observe high standards of prudence and probity in their day-to-day behaviour and operations. The encouragement of such values by central agencies is, of course, very beneficial to effective management control, and the INTOSAI Guidelines stress the importance of a supportive attitude for sound management control (I, para. 24).

While there is no single model for the organisation and duties of the central agencies of national governments, three distinct roles are often found at the centre of government in a number of countries with jurisdictions similar to those of Canada. These are described below.

Advisers to the Prime Minister and Cabinet

While the Prime Minister, like other ministers, maintains a small private office staffed through political rather than public service appointments, he is also supported by central agencies within the public administration. They provide policy analysis and advice to the Canadian Prime Minister and also to the Cabinet under the convention (noted above) that, in certain matters, Cabinet has a collective responsibility transcending individual portfolios.

Information and advice by central agencies to the Prime Minister himself is mainly to support his roles in:

- mediating disagreements/building consensus among ministers on issues coming before Cabinet for decisions;
- determining the overall organisation structure of government and assignments of competence among ministries (for which he enjoys substantial discretion);
- appointing and managing the most senior civil servants in ministries and agencies.

Information and advice by central agencies to Cabinet, as such, reflects its collective responsibility in Canada for:

- organisations and management of the public service;
- federal-provincial relations;
- budgeting and expenditure management.

A recent example of corporate advice related to an announced massive reduction in the size of the public service by 45 000 employees over a three-year period (about 15 per cent of the total, but a much larger percentage in some ministries). Prior to this announcement, central agencies gave their advice to the Prime Minister and the committee of ministers assigned to this undertaking about what would need to be done and what it would cost to encourage a large number of public servants to accept early departure and early retirement. They also advised on the possible overall impact on service to the public (mainly on the basis of information they had received from individual ministry proposals for reduced personnel).

With respect to the accountability of central agencies, their performance is largely judged on the quality of their corporate advice. While the results deriving from their advice are sometimes difficult to assess, they are often quite clear, as the case just mentioned shows. Subsequent to the announcement and early implementation of the staff reduction plan, it was found that response to the departure incentives was much larger than expected, an indication that the central agencies' recommended incentives were too generous. The result was higher costs than necessary and public service delivery problems because of inadequate staff in the short term.

Central agencies also give advice on the best candidates to fill the most senior public service positions as well as positions for the chief executive of state enterprises, known as Crown Corporations in Canada.

They also have a crucial role in providing advice on federal provincial relations, whether in the course of major projects to amend the Constitution or in agenda management for the regular meetings of the Prime Minister with the 10 provincial Premiers.

Another key responsibility of central agencies is for management of the public service. While this is a less publicly stated responsibility, it is nonetheless very real and important. It should be noted that this responsibility concerns management of the public service, not the government. It is led by Canada's most senior public servant, who reports directly to the Prime Minister and holds the title of Clerk of the Privy Council. In effect the Clerk is Deputy Head of the Prime Ministry.

While the legislature and the Treasury Board approve the laws and policies that govern the government-wide activities of the public service, most of the important reform proposals affecting the management of the public service stem from the Clerk's office. The Clerk is recognised as the person who leads the implementation of the reforms, once they are approved by Cabinet. For example, the Clerk conceived and led the implementation of one of the most significant reforms in the history of Canada's public service, known as Public Service 2000. It focuses on a more innovative, service-oriented public service, one that uses the most modern, cost-effective management methods. In addition to leading its implementation, the Clerk now prepares an annual public report addressed to the Prime Minister on the progress being made to achieve the Public Service 2000 objectives.

Human resource management

A central agency may fulfil the role of employer of all public servants, usually under specific legislation for this purpose. This includes setting the terms and conditions of employment in the public service and the classification and pay levels. In addition, they may act for the government in collective bargaining with the unions and to develop training and development programmes that are common to all ministries. In Canada, the Treasury Board fulfils these responsibilities.

Central agencies of government would not normally be responsible for staffing standards and rules, as the legislature prefers its own agency to have this role in order to preserve the merit principle, that is, to ensure that public servants are hired on the basis of qualifications rather than political contacts or any other means where there might be bias. In Canada, this agency is called the Public Service Commission (see Section 1).

Budgeting and expenditure management

This role has both an internal and external focus. It involves overseeing the country's financial affairs through good fiscal management, such as developing the government's budget proposals, monitoring government borrowing and debt management services, managing the government's banking, and recommending and maintaining the legal and policy framework for taxation, including customs duties. Expenditure management is closely linked to fiscal management and involves the development and maintenance of the government's system for reviewing expenditure plans from the ministries and allocating resources on the basis of the government's priorities and fiscal plan. It also includes consolidating the government's expenditure requirements and submitting the expenditure Budget or Estimates for approval to the legislature. In Canada, this is part of Cabinet's collective responsibility because of the constitutional convention that the Estimates cannot be amended by Parliament which can only defeat the Estimates by defeating the Government.

In many countries the Treasury is a separate organisation operating as a central agency for cash management, debt management, the centralised payments system and fiscal accounting. In the Canadian case, policy and standards for these functions are set by the Ministry of Finance and the Treasury Board while the actual operations are carried out by a service ministry called Receiver General of Canada.

Other

In addition to these fairly well-established roles, central agencies in Canada have some other administrative responsibilities, such as central procurement and policies on information technology. Functions such as these are central because of the need to meet certain government-wide objectives. As

mentioned in Section 1, functions such as procurement are also subject to specific TB management control standards. INTOSAI recognises that these kinds of administrative activities form one of the groupings for which control standards are necessary (I, para. 35).

3. How management controls are developed in Canada

This section builds on the summary description in Section 1 and, to some extent, on Section 2. It describes in more detail how management controls are developed by the central agencies in Canada's government.

Legislative basis for management controls

Legislation is the basis for Canada's management controls. In Section 1, it was stated that the Financial Administration Act is the principal legislation for management controls, as it requires the government to establish a specific authority, the Treasury Board, to develop and promulgate controls for government ministries. However, the legislature also prescribes certain detailed controls in the law. For example, the FAA contains the following provisions on the control of financial commitments:

No contract ... providing for a payment shall be entered into ... unless there is a sufficient unencumbered balance available ... during the fiscal year in which the contract ... is entered into.

The deputy head ... shall, as the Treasury Board may prescribe, establish procedures and maintain records respecting the control of financial commitments.

This text forbids the government from making contracts (commitments) with outside parties if no money has been authorised by the legislature for this purpose; it also requires the DH of each ministry to maintain appropriate accounting and controls for commitments, in accordance with TB guidance.

The legislature also prescribes controls to preserve the principle of the separation of duties (I, para. 54):

No payment shall be made ... unless ... a person ... authorised by the appropriate Minister certifies ... that the work has been performed....

No charge shall be made against an appropriation except upon the requisition of a person ... authorised by the appropriate Minister....

Every payment ... shall be made under the direction and control of ... in such form and authenticated in such manner as the Treasury Board prescribes.

It is worth noting that the phrase seen above, "as the Treasury Board prescribes" is a common occurrence in Canadian laws and its effect is to give TB policies the status of regulations backed by legislation.

TB policy under the above laws, for example, stresses the strict separation of duties (I, para. 54). The Minister of each department must assign the line managers of each budget responsibility for certifying that the goods or services invoiced have been received and conform to what was ordered in terms of quality and price. The Minister must also assign the independent financial officers (not involved in the buying transaction) responsibility for: *i*) certifying that the invoice is properly supported by the required

documentation, such as matching purchase order and signed receiving slip, that the manager's signature is valid, and that the resulting charge is to the right appropriation and in accordance with the prior commitment authority; and *ii*) preparing and signing a valid requisition for payment. In addition, TB policy requires that the Receiver General (the Government Payments Office) properly authenticate the signature on the payment requisition before issuing the cheque.

In addition to a number of provisions of this kind in the FAA, there are also other pieces of legislation in which the legislature maintains important controls. There is, for instance, a Public Service Employment Act, which prescribes a number of human resource controls, for example, that no new salary levels may be instituted without the approval of the Treasury Board. There are other Acts dealing with controls for particular government programmes as opposed to the government-wide controls administered by the Treasury Board Secretariat, such as the National Health Act and the Customs and Excise Act. Such specific Acts take precedence over the FAA and any TB policies. This can sometimes present a problem for auditors, as they have to ascertain which control takes precedence when carrying out a compliance audit.

Until the late 1970s, the duties and responsibilities of the Auditor General were included under the FAA. However, there is now a separate Auditor General Act, which clearly establishes the independence of this office from the government. Among other things, it authorises the Office of the Auditor General to be a separate employer, free from the restrictions of the Public Service Employment Act, thereby enabling the Auditor General to pay somewhat better salaries than the rest of the public service in order to recruit competent auditors. It also gives the Auditor General the power to undertake audits of the efficiency of government operations and ministry procedures for measuring the effectiveness of their programmes. This power is clearly within the realm of management control.

Controls that ensue from legislation

In developing its management controls, the first task of the Treasury Board is to ensure the implementation of the control standards that exist in legislation. In fact, many of the legal control standards specifically require the Treasury Board to provide direction on how to implement them, as they contain qualifiers such as the phrase "as the Treasury Board may prescribe", which appears in the texts cited above.

The TB's role is to ensure that these mandatory requirements of the legislature are well understood and properly implemented to fulfil their intended purposes. Its role is also to ensure that the various requirements are communicated in such a way that they complement each other rather than work at cross-purposes (I, para. 11). For example, there is one legislated control standard that forbids spending a ministry's own revenues without legislative authority while another provides ministries special authority to spend the proceeds from the sale of surplus property. In this case, the Treasury Board manual explains that the latter authority overrides the former. The Treasury Board does the initial drafting of such provisions by the legislature, to help that the legislation will not create problems of interpretation.

The Board's role in developing and promulgating the framework is also to ensure that detailed directions to ministries permit consistent interpretation of the legislative requirements. For example, it is imperative that the same accounting principles should be followed within a government-wide chart of accounts. While this is not prescribed in legislation, it must be part of TB policy if the FAA requirement that the government produce audited government financial statements is to be met. Otherwise, it would not be possible to aggregate financial transactions across government.

Once policy objectives under each piece of legislation have been determined, the TBS expert must decide on the level of detail needed in the implementing directives. In some cases, a statement of policy objective and some general guidelines will suffice; in others, the method of implementation may be crucial

and must therefore be written into the policy. A legislative control standard that forbids making any payment without legislative authority may, for example, not need further elaboration, whereas implementation of a standard stating that the government shall maintain accounts to show contingent liabilities may need direction, as it covers an area that is quite complex and not readily understood by most public servants.

Depending on the legislative provision, the direction given by TB to ministries for complying with each piece of legislation may be restrictive; for example, under Treasury Board policy a ministry may not write off a debt larger than \$X without TB approval. Others, instead, may be enabling; for example, under Treasury Board policy, a fee may be charged for the use of a public facility. In each case, the Board, with its overall responsibility for management controls, assesses the risk of non-compliance or abuse or, on the other hand, the opportunity that the standard provides, and writes policies accordingly.

In the case of writing off of debts, TBS felt that there was a high risk that debts would be written off before adequate effort had been made to collect them. It therefore wrote a policy requiring ministries to follow stringent procedures before write-off action is taken. These procedures require each ministry to set up a debt write-off committee whose role it is to challenge all write-off proposals within the ministry, according to criteria established by TB, so as to ensure that every reasonable effort has been made to collect the debt. In the case of charging, TB believed that ministries needed to be encouraged to charge for facilities and therefore introduced an incentive by allowing ministries to receive credit in the next budget allocation for the increased revenues they achieved from charging.

Controls emanating from central agencies

In addition to policies ensuring implementation of legislated control standards, TB has authority to determine what additional policies it may wish to introduce under its own general authority for good management. To do this, it determines if there is anything lacking with respect to: *i*) safeguarding resources against loss due to waste, abuse, mismanagement, errors, and fraud and irregularities (I, para. 7); and *ii*) whether or not its current policies are reflecting adequately the needs and opportunities of the current and anticipated environment, including the priorities and objectives of the current government.

The safeguards or protective controls are clearly a function of risk. Policies for dealing with risk are developed on the basis of the probability that an undesirable event will occur (how likely is it that it will happen?) and the consequences if it does occur (would there be a serious monetary loss or an embarrassing situation that would damage the reputation of the public service and the government?).

High-risk situations justify greater investment in protective controls than lower-risk ones. On the other hand, TB strives to make its policies as cost-effective as possible (I, para. 12). For example, its policy on verification and payments controls allows for less control over some transactions than others. It simply provides general guidance on how departments may exercise control; for example, it suggests that an invoice from a well-known and very reliable supplier, such as the telephone company, may need very little checking even for a large sum of money, while an invoice for a relatively small amount from a new and untested supplier should be checked carefully. In addition, it encourages ministries to use modern techniques, such as statistical sampling, to process quantities (batches) of invoices. Such approaches are less costly and often more reliable.

In response to a new or changing environment, consistent with the Public Service 2000 initiative, the government publicly stated that it would substantially reduce the costs of controls by making ministries more accountable. In response, TB increased delegated authorities to ministries by amending its approval thresholds, such as the dollar amounts of contracts that required prior TB approval. Unfortunately, a recent

analysis has shown that the proportion of competitive tender calls for government contracts has decreased, an indication that some ministries may have abused this new delegation. As a result, the TB Secretary has set up meetings with the deputy heads of the ministries concerned to determine the reasons for the decrease in competitive contracts. If it is proven that abuse has occurred, this will be reflected in the performance review of the deputy heads (see Section 1, under "Monitoring and evaluating management control systems").

Also with respect to responding to change, when the government decided that it should be a leader in the use of information technology, TB approved a new arrangement (not an official policy) that allows ministries to "borrow" funds from a central reserve in order to invest in new technology, provided the money is reimbursed from future savings. In reality, under current government accounting procedures, ministries can neither borrow nor invest. However, this borrowing and investing is being simulated through internal reallocations within legislative authority. When the government moves to full accrual accounting (announced for the year 2000), these normal business practices can be used without the need for simulations which are less effective and riskier.

Use of information technology for better and more cost-effective controls

The drive to exploit new information technologies has created new control challenges for TBS. This drive comes from both public sector managers who want to use this technology to reduce costs and improve service, and from those doing business with the government, such as banks and large businesses with sophisticated technologies at their disposal. Government and its managers are also, of course, constantly being solicited by large hardware, software, and telecommunications suppliers. In response to these challenges, TB has recently developed and issued new policies on electronic authorization and authentication and a number of standards on electronic data interchange and electronic funds transfer. It has also, with parliamentary approval, made changes to the FAA to allow entirely electronic payment, receipt, transfer, and deposit of funds; previously, these transactions required physical evidence in the form of paper or computer tape.

TBS believes that controls are more effective if they are built into a normal managerial operation, rather than added on and thus perceived as a burden. Technology is making this easier. For example, experimentation with expert travel system software is under way in Canadian ministries; this software makes possible full automation of the travel authorization and procurement process, the controls for which have been very onerous for government managers who have to travel. Under this system, a government traveller completes a travel request by means of his or her desk-top computer and follows all the rules simply by clicking a mouse in response to a series of simple questions supported by pictorial icons. If the traveller clicks something for which he or she is not entitled, a message appears on the screen and shows the rule that disallows this item. If the extra entitlement can be authorised by a superior, the computer programme shows the traveller on the screen how it can be obtained through electronic authorization. An example might be a need to rent a larger car than is normally allowed under the rules.

On average, the traveller completes a travel request that is fully priced, authorised, and in accordance with all the rules within a few minutes. This expert travel system will later provide the basis for very rapid completion of a travel claim and audit. One might argue that a better control would be to replace travel rules by a per diem. This kind of thinking is consistent with process re-engineering, which TBS is supposed to undertake before recommending the use of new technology. TBS did in fact do so, and a pilot study in one of the ministries showed that the per diem method was less cost-effective, as it tended to increase overall travel costs significantly.

In addition to using expert systems for control, other projects are under way to make use of commercial techniques, such as electronic data interchange and electronic funds transfer. These automated control mechanisms also use electronic authorization and authentication and are supported by proper security methods, such as data encryption and decryption using private and public keys. Like expert systems, they provide better control, as there is less opportunity for error because information is only entered in the system only once instead of several times by different persons and organisations.

Controls under what is becoming known as "electronic commerce" are much more user-friendly than manual controls or fragmented computer controls. They also provide much better cash management, another important control. The Canadian government uses them for: *i*) multi-billion dollar tax collections, with corporate and individual taxpayers now able to submit tax information and make accompanying payments or receive refunds electronically; *ii*) multi-billion dollar collections of employee payroll source deductions, whereby large employers must submit electronically total dollars deducted and all the supporting details of the amounts deducted, by employee name, for income tax, state pension, and unemployment insurance contributions; and *iii*) electronic ordering, without any paper work, of goods from suppliers, following up on delivery, acknowledging receipt, authorising and making payment.

Given the need to reduce costs and improve service and control all at the same time, the arrival of better information technology is fortunate, as it provides many creative ways to bring about better and more cost-effective controls. Only a few of the successes have been mentioned here. While, so far, no significant failings have been found, there is some anxiety that the impetus to use new technology may cause some ministries to implement new major systems or make changes to existing systems too quickly, without adequate attention to the design of built-in control features in accordance with TB standards.

Responding to differing ministerial control needs

TBS does not develop its policies in isolation. It consults extensively with the ministries that have to implement these policies to ensure that they are sound and cost-effective, and -- particularly important in a decentralised environment -- that they have sufficient flexibility to meet differing circumstances. It also consults with professional associations, such as accounting institutions, to ensure that it is using the most modern and practical approaches to achieve the policy control objectives. For significant policy changes, it often consults with the Auditor General, but always on the understanding that any views he or she gives will not affect his or her right to audit the policy independently when it is implemented.

TBS is also very responsive to requests from individual ministries for special control needs or justifiable exemptions within the overall management control framework. This is in recognition of the fact that the diverse nature of government programmes and operations often makes it necessary to tailor some of the controls that are under TB jurisdiction. If a ministry can demonstrate that a departure from a control will enhance programme delivery or save money in a given situation, TBS endeavours to respond as long as there are no serious additional risks.

TBS showed its willingness to be flexible in its policies in the case of one ministry, which was considerably delaying the deposit of large sums of cash from remote locations because, under TB policy, such cash transfers were only made every five days so as to save bank transfer costs. This policy, however, had been established at a time when such cash transfers involved very small amounts. As the ministry pointed out, this policy was costing much more in interest for the government than the bank transfer costs and, in addition, keeping such large sums on site was creating the risk of robbery or theft. This ministry therefore received TB exemption from this policy.

In other cases, new developments in certain ministries sometimes require the Treasury Board to seek legislative change if the required control change is not within the authority delegated to the TB. One example is the changes made to the FAA to facilitate electronic banking which were mentioned above. Initially, these control changes were made solely to enable the tax collection ministry to use electronic commerce to make significant savings and improve customer service. Later, many other ministries required this authority.

4. Factors affecting management control in Canada

Responding to change

Management controls need to be continually updated to reflect changes in the environment, a point touched on in the INTOSAI Guidelines (I, para. 15). The current status in Canada is not fully satisfactory. Indeed, while some new managerial reforms should, in theory, have strengthened management controls, Canada's Auditor General has serious concerns about the current situation.

As mentioned in Section 2, Canada's recent public sector reforms have focused on improved service to the public. A key theme in achieving this goal is empowered management, coupled with greater accountability. This theme is being supported by clearer delegation and the introduction of better planning and performance reporting. In this regard, the Treasury Board Secretariat has developed and promulgated specific frameworks for:

- business planning, which essentially requires ministries to submit annual strategic plans that explain in broad terms how they intend to achieve programme outputs and outcomes and how these results will be measured (previously, detailed plans for individual expenditure items and activities were submitted, and ministries felt that this provided TBS with an incentive to "micro-manage" them from the centre);
- quality service, which requires ministries to focus on quality services to the public -- and internally where applicable -- in terms of accessibility, timing, and affordability (including, this year, the requirement that ministries publish their service standards);
- accountability, which provides criteria under general categories of management (which ministries can adapt to their own programmes and any unique circumstances) for providing accountability upwards through each ministerial organisation and then onwards to Parliament (acting for the taxpayers at large).

Accountability for the management controls framework

The TB accountability framework also includes new criteria for the respective accountabilities of ministries to the Treasury Board (generally, for meeting the TB policy requirements that encompass the management control framework) and the accountability of TB with respect to the quality and effectiveness of its frameworks. For instance, if the Auditor General (AG) finds that all ministries are having difficulty implementing a TB policy, this is indicative that there is a flaw in the framework or the way it is being monitored.

A recent significant example of TB's accountability involved misuse of an employee lay-off policy designed to reduce staff by paying special departure incentives. Instead of eliminating jobs, ministries were using this policy to dismiss unproductive employees whose work still had to be done.

When the Public Accounts Committee (the legislative committee primarily responsible for reviewing the AG's reports on management control issues) read the AG's report on this matter, it held the Treasury Board Secretary accountable for not monitoring this situation and reducing the heavy incidence of non-compliance (which happened over a three-year period) that cost the taxpayers several hundred million dollars. While the issue was not publicly raised, it might be said that the policy was flawed because it failed to take into account the ministries' legitimate need to remove unproductive employees.

A blueprint for information technology

In addition to the new frameworks, the TB Secretariat has published a blueprint for improving government services through information technology. This document lays out, for government ministries and the public, a number of principles, standards, and goals for maximising the use of information technology to improve the efficiency and quality of internal government (within the ministries) and of services to the public by the ministries. The preface to the INTOSAI Guidelines (I, para. 1) recognises the need to place greater reliance on automated technologies.

The blueprint focuses strongly on the use of new techniques, such as process re-engineering, as a prerequisite to investments in information technology. It also envisages significant partnering with the private sector and other levels of government to develop and use information technology to improve efficiency and service. To achieve this and other goals of the blueprint, a number of important committees and councils have been established, such as the Advisory Council on the Information Highway.

The blueprint's objective of partnership between the private sector and other levels of government is commendable. However, while it provides opportunities, it also presents significant new management control challenges to TBS because of the high risks involved. Government managers entering into such arrangements are often not well-trained or experienced enough in contract, project, and risk management to ensure that the interests of the government are fully protected. Also, the government is not legally entitled to enter into partnership arrangements without parliamentary authority, because under Canadian law a partner is fully liable for the debts of the other partners in the project. Managers, therefore, have to be sure that shared undertakings do not result in partnerships in any legally binding sense.

Fostering self-control by managers

While not a specifically stated objective, these frameworks to modernise the public service should contribute to a better framework for management control. This is because they require clearer responsibility and accountability in each ministry and encourage the use of new, modern tools that help managers control themselves instead of being controlled by the centre and ministerial experts. Managers are now, for example, beginning to use expert information systems and electronic authorization and verification methods that enable them to make informed decisions without needing to have a knowledge of detailed administrative procedures.

This modernisation of controls and the concept of self-control are also changing the role of central agencies with respect to ministries, which is evolving from directing towards enabling, guiding, and co-ordinating. Central agencies are actively trying to foster self-control by managers in place of control from the centre. Overall, their purpose is primarily to provide leadership in the best management control practices consistent with the legislative framework and the current objectives and goals of the government. This transition from strong central control to control by managers is clearly recognised in the INTOSAI Guidelines (I, para. 1).

Concern of the Auditor General

The Auditor General of Canada is generally quite supportive of Public Service 2000 and the various initiatives that have evolved from it. However, he has expressed concern to the legislature that the central agencies have not developed a specific framework for control that reflects these reforms. While he has not referred to INTOSAI, he is, in effect, advocating its management control framework for the Government of Canada.

He also feels that, while the existing controls have been reasonably reliable in the past, they do not correspond to the current environment. It is his opinion that even though greater delegation of authority and output-oriented controls should provide better service to the public, they do present greater risks if they are not supported by sound and clearly understood management controls. He is particularly concerned about a perceived imbalance between autonomy and accountability, as he has not yet found improved accountability measures, principally through ministerial information systems, that provide evidence of how well managers are exercising their greater decision-making powers.

**THE CASE OF THE NATIONAL WELFARE ACT
(Netherlands)**

by

**Christianne E.P.M. den Houting-Stevens
Henny S. de Vos-Koerselman⁵**

Executive Summary

This study of the National Welfare Act in the Netherlands shows how the management controls of a specific ministry, the Ministry of Social Affairs and Employment, are structured so as to allow the Minister of Social Affairs and Employment, who has legal responsibility for the formulation, evaluation, and possible adaptation of central social security policy, to take responsibility for expenditures and later to account for these expenditures to Parliament.

The implementation of the National Welfare Act is a good example of the accountability process. This process is part of the administrative organisation, which includes many instruments of management control or internal control. It starts when the Minister of Social Affairs and Employment receives from Parliament a budget for the National Welfare Act. As the study shows, management controls have been built into the entire legal and administrative structure of the programme. The responsibilities of those involved are clearly indicated.

On the basis of the National Welfare Act, the municipalities grant benefits to persons entitled to them. A public decree defines "eligibility", the personal circumstances that affect benefit level, and the standards of evidence required. All 630 municipalities receive monthly contributions from the Ministry in the form of an advance. The size of the advance is based on a cost guideline and is evaluated by the Ministry using standard procedures and questionnaires.

State consultants, acting for the Ministry, carry out various examinations of the municipalities every year, in order to verify how the municipalities implement the National Welfare Act. Their activities are defined in working instructions, and they prepare a standard report. In addition, they also compile an annual report describing any and all notable developments and bottlenecks in executive practice; these are to be used for evaluating and, if necessary, adapting central policy for the National Welfare Act.

In addition, the municipal auditor furnishes a legally required report which is attached to the municipality's financial accounts. The Minister has created an additional protocol for checking the municipal auditor's control of the implementation of the National Welfare Act, in order to verify that the contributions have been spent properly. This process has become part of the management control and internal controls of the Ministry of Social Affairs and Employment.

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The Ministry settles the final amount of contributions to the municipalities on the basis of definitive cost statements, making use of the work of the state consultants and the municipal auditor. The departmental audit service then audits the financial accounts and the relevant administrative procedures and prepares a report. The purpose here is to confirm that the Ministry's management control instruments comply with requirements.

These measures allow the Minister to take responsibility for budget expenditure and account for that expenditure to Parliament.

1. Framework for management controls in the Netherlands

Authority for management controls

Parliament is the highest level of authority for management control in the Dutch government. The most important Act in this regard is the Budget and Accounting Act. Parliament also provides instruments for management control in other legislation (such as the National Welfare Act, as described below).

The Budget and Accounting Act gives the Ministry of Finance a special role in management control. The Ministry of Finance has to develop instruments and instructions for management control for the other ministries. As these rules and regulations are very broad, the ministries have some flexibility in carrying out this responsibility.

Development and promulgation of management controls

The Ministry of Finance has prepared manuals that lay down standards for financial accounts and management control. The manuals are produced in co-operation with internal and external auditors. From time to time, the manuals are amended, as suggested in the INTOSAI *Guidelines for Internal Control Standards* (I, para. 66).

Each ministry has a secretary general whose role is defined in legislation (Royal Degree). He or she is the highest civil servant in the ministry and has responsibility for personnel, finance, administration, and management. Each ministry also has a director of finance and accounting, who is responsible for developing and promulgating management controls in the ministry. The secretary general, the director of finance and accounting, the director of the departmental audit service, together with the directors of all the divisions in the ministry, form the Audit Committee. This Committee plays an important role in developing and promulgating management controls in the entire organisation. Financial management, management control, and the departmental audit are issues discussed by the committee.

The departmental audit service is also involved in promoting the rules and regulations prepared by the Ministry of Finance. In addition, the departmental auditors give advice on translating the rules into good practice.

Role of the Netherlands Court of Audit and the central agencies

The Netherlands Court of Audit (*Algemene Rekenkamer*) has no formal role in the promulgation of standards of management control. It is, however, indirectly involved in the performance of management control systems, as its audits are systems-based, that is, they are based on the management control systems. Therefore, the Court of Audit can make recommendations which may lead to amendments in the manuals of the Ministry of Finance.

The Dutch constitution simply states that the Court of Audit is responsible for auditing state revenue and expenditure. The Court of Audit considers the improvement of the functioning of government as its mission, and it carries out this mission by regularly presenting to the government and Parliament the results of its audits. It identifies shortcomings and indicates the scope for improvement, all with a view to ensuring that the taxpayer's money is spent in the best possible way.

The Netherlands Court of Audit is totally free in its decisions to investigate. Its independence is ensured in part by the fact that members of the Board are appointed for life. A new government cannot therefore dismiss them and replace them with persons of its own choice.

Comparison with the INTOSAI Guidelines

The general and detailed standards laid down in the INTOSAI Guidelines (I, paras. 4 and 5) are only implicit in audit programmes of the departmental audit service and in the manuals of the Ministry of Finance, because the Ministry's manuals and guidelines already existed before the INTOSAI Guidelines were approved in 1992. The Netherlands Court of Audit co-operated in the realisation of the INTOSAI Guidelines.

Monitoring and evaluating management control systems

A ministry's internal audit service is responsible for monitoring and evaluating the management control systems. Some of their reports are discussed in the Audit Committee.

The oldest and most basic activity of the Court of Audit is the financial or so-called "regularity" audit. The main focus of this kind of audit is approval of the State Account. For the past few years, these audits have also covered the administration and the financial management of the departments. In practice, the Court's audits are mainly based on the findings of the internal audit service of the body audited. The Court uses a review procedure to determine whether the opinions of the internal audit service of the ministry and its report can be relied on (I, paras. 83 and 84). Enormous improvements have been made in this area over the past ten years.

In the mid-1980s, ministries were struggling with poor management control. Everywhere, this was resulting in huge backlogs in the annual financial accounts and the financial audits. Audits, carried out after enormous delays, showed many irregularities. It was often unclear whether expenditures had been made in compliance with applicable laws and regulations. Partly with guidance from the Court of Audit (I, para. 66), the so-called "Government Accounts Reform Operation" was started, aimed at:

- improving the administrative procedures and management control of the ministries;
- strengthening the internal audit (referred to here as departmental audit);
- expediting the circulation of (financial) information in the federal government and between government and Parliament;
- improving the budget presentation.

This operation resulted in vast improvements in the field of administration, auditing, and financial accounting. Financial accounting is now done annually. It is audited by the internal auditor, who also provides an auditor's report. Management control procedures now meet the minimum requirements in all ministries.

The findings of the Court are presented in its reports. The Minister of Finance prepares consolidated accounts of all ministries, which form the State Account, which must be approved by the Court of Audit. Objections arising from regularity audits must be dealt with before the State Account can be approved by Parliament.

The fact that the Court of Audit has deemed expenditure to be legitimate does not necessarily mean that the money has been well spent. The Court of Audit also carries out performance audits. These audits are concerned with the proper expenditure of money in the sense of maximum economy, efficiency, and effectiveness. The Court of Audit seeks to strike a balance between regularity and performance audits.

In the case of performance audits, there are no statutory sanctions. However, the Court of Audit can publish its findings and can continue to pursue a minister by means of follow-up audits.

Resources, skills, and training for management control systems

Each ministry has to ensure that its personnel have the resources and skills necessary to do their job. This means that the manuals and guidelines of the Ministry of Finance should be available in each ministry. But even more important is the need to hire the best people. Therefore, it is necessary to define the qualifications needed for a given position and to have sufficient resources to recruit the staff required. The Secretary General of each ministry is responsible for recruitment policy. The Ministry of Finance organises training in the use of the manuals and guidelines on management controls.

2. Management control and the National Welfare Act

This case study gives an example of how a ministry's management controls are established so that the minister can verify expenditures and report to Parliament. (Audits by the Court of Audit are mainly based on examination of these management controls.) It concerns benefits paid to individuals under the National Welfare Act; these are the largest social benefits accorded by municipalities, and, with the benefits granted under the Child Benefits Act, (which are distributed by a special agency) they receive the most intense scrutiny by the Ministry. Other benefit schemes (such as unemployment, sickness, and disability) are carried out by independent organisations of employers and employees, the premiums being paid by the wage earners.

Before explaining the procedures involved, it is useful to review the budgetary system, explain the main features of a specific benefit under the National Welfare Act, and give a general introduction to the Act.

The budgetary system

Ministries, or government departments, are part of central government. They help the responsible ministers to do their job as well as possible. Each ministry has a number of tasks that are important to society as a whole, such as looking after public health (the Ministry of Health, Welfare, and Sport) or maintaining a proper infrastructure (the Ministry of Transport and Communications).

In the Netherlands, each minister is allocated an annual budget, which is to be spent on activities determined in advance. At the end of the year, the minister has to account to Parliament for the budget expenditures; the principle of ministerial accountability is fundamental to the Dutch democratic system.

In order to ensure ministerial accountability, that Dutch ministries must set up their administrative organisation and their management controls so as to ensure control of and accounting for the spending of the available budget.

Specific benefits

Specific benefits is the term used for certain contributions by the state to municipalities, among others, which are budgeted annually and entered in the financial accounts of the ministry concerned.

"Specific benefits" is a collective label for payments from the state to lower-level authorities, which are generally intended to be used for centrally defined tasks. As a rule, lower-level authorities are not free to spend the amounts as they see fit. They must remain within the applicable guidelines and regulations associated with each benefit. These laws and regulations determine the scope of action within which the lower level has the freedom to use its discretion. In the Netherlands, this is known as "co-government": tasks are carried out at a lower level for the state, and the state sets the rules that the lower authorities must abide by when executing the task in question. It is important to note, however, that although the lower-level authorities are responsible for execution, the state -- in this case the ministry that has allocated the contribution -- is responsible for ensuring that such expenditure is properly incurred and legitimate. These are eventually, as indicated earlier, listed as expenditures in the financial accounts that the ministry sends annually to Parliament.

In general, specific benefits are administered through a system of prepaid advances which are rectified after the fact. Definitive determination of the ministry's contribution and settlement of what it has overpaid or underpaid takes place after the fact, that is, once the municipality in question has accounted for the spending of the contribution.

The National Welfare Act

The National Welfare Act took force on 1 January 1965. With the introduction of the law, the government took it upon itself to provide financial assistance to every Dutch inhabitant not having the means to provide for the basic necessities of life. The National Welfare Act is a safety net of last resort, and benefits based on this law are only paid if one cannot apply for any other social security benefit. During 1994, approximately 510 000 people received a benefit through the National Welfare Act.

The implementation of and control on the National Welfare Act is a complex affair. Originally, the law was simple, and payments for all those who were entitled to benefits were determined on the basis of identical criteria. Through amendments, since the mid-1980s, the level of benefits are made dependent on the recipient's personal situation, so that there are great variations. Before benefits are paid, it is necessary to determine precisely the category into which the entitled person falls. There is (occasional) abuse and improper use, as one category provides a higher benefit than the other.

The National Welfare Act will cost over Gld 11 billion in 1995. Of this, 90 per cent will be provided by the state and 10 per cent by the municipalities.

Overall responsibility for the National Welfare Act lies with the Minister of Social Affairs and Employment, who is therefore responsible for supervising the manner in which the municipalities implement the Act. He or she has to account to Parliament for its supervisory activities and for all expenditures and receipts based on the National Welfare Act included in the ministry's financial accounts. In addition, the Minister of Social Affairs and Employment is legally responsible for formulating, developing, and evaluating the government's social security policy. This responsibility is described as follows:

The state government [in this case the Ministry of Social Affairs and Employment] is responsible for the general level of social security, for adapting levels of social security to the national policy framework and for the quality of central enforcement of regulations.

The National Welfare Act and the relevant ministerial responsibilities are the basis for the management control process used with regard to this Act.

3. Main lines of the implementation of the National Welfare Act

Execution

Under the National Welfare Act, the municipalities receive an advance from the Ministry on a monthly basis. These advances cover the payments to those who are eligible, which are made by the municipalities in the name of the state. The Ministry calculates the monthly advance on the basis of a provisional cost listing from the municipality concerned, among other things.

The municipalities are responsible for paying benefits based on the National Welfare Act to persons entitled to them. In addition, they must verify periodically whether the benefits require adaptation owing to changes in a given individual's circumstances. Furthermore, the municipalities actively guide persons receiving benefits in order to encourage them to find work and cease claiming National Welfare Act benefits.

Final settlement of the advances received by the municipality takes place subsequently. To this end, each municipality submits a definitive statement of expenditures to the Ministry within a certain period after the end of the year. This statement is accompanied by a municipal auditor's report. The Ministry evaluates the statement, after which the final amount owed one party or the other is determined. The difference between the final costs and the advances received is either paid to the municipality or collected from it.

The Minister of Social Affairs and Employment gives an annual account of the Ministry's activities in its financial accounts, which include the expenditures and receipts for the National Welfare Act. As mentioned, the financial accounts of ministries include an auditor's report, issued by the departmental auditor.

In order for the Minister to be able to give an account of the expenditures and receipts pertaining to the National Welfare Act, he or she must be certain that they are accurate and legitimate. Accuracy means that the information for the National Welfare Act contained in the Ministry's financial accounts is true and accurate. Legitimate means that the expenditures and receipts effectively complied with the legal regulations of the National Welfare Act and other underlying regulations.

The procedure followed by the Ministry of Social Affairs and Employment essentially has three phases:

- the issuance of the advances from the ministry to the municipalities (responsibility: line management);
- the evaluation of the definitive costs and the definitive determination of the costs based on the findings of the municipal auditor and the work of the state consultants (responsibility: line management);
- the verification of the financial accounts of the Ministry by the departmental audit service (responsibility: staff).

The first two phases are discussed below. The procedures to be followed by the Ministry in this respect have been set out in official policy documents (I, para 43) and indicate, point by point, the departments and directorates involved, at what point, why, what actions have to be carried out, and how all this is to be documented.

A vast number of internal controls have been included in these procedures. Examples include: visual supervision, function separation, records, and so forth. Creating and maintaining these procedures is the responsibility of the line management. In line with the INTOSAI Guidelines (I, para. 2), these management control structures provide the Minister reasonable assurance that the objective of orderly, economical, efficient, and effective operations, which comply with laws, regulations, and management directives, is being achieved.

Some of the main instruments of management control used by the Minister to achieve internal control are as follows:

- a Public Decree, defining an "eligible person", the personal circumstances affecting the level of benefits, and the standards of evidence required;
- a *Claims Processing Manual* setting out the steps in the procedure to be followed by all municipal offices;
- prescribed work instructions for the state social security consultants for determining whether the municipality has properly followed laws and regulations (cf. the Public Decree mentioned above);
- a statement defining the content of the report of the state social security consultants;
- a cost guideline for determining the size of the advance for the municipalities;
- the National Welfare Act Control Protocol for municipal auditors;
- a statement defining the content of the municipal auditor's report;
- standard procedures and questionnaires for departmental evaluation of the advance;
- standard procedures and questionnaires for departmental evaluation of the definitive cost submissions;
- a statement defining the frequency and depth of review of the internal control structure;
- the mandate of the departmental audit service.

The departmental audit service is also involved in the creation of the descriptions and statements. In this respect, the service later verifies whether the required procedures have been observed.

The issuance of advances

All of the more than 630 municipalities in the Netherlands receive an advance every month. Evaluation of the cost guidelines provided by the municipalities and determination of the size of the advance on that basis are relatively simple. If the municipalities have met certain formal requirements and

the provisional cost guidelines parallel expectations, the advance is set in accordance with the provisional calculation of the costs. Payment of advances must be justified by the Ministry.

Internal control measures are aimed at:

- paying an advance only after the cost guideline has been evaluated;
- paying an advance to the proper municipality;
- proper and complete accounting of the advances issued by the ministry.

The issuance of advances is fairly risk-free for a number of reasons. First, the work is fairly routine, relatively simple, involves few complex evaluation processes, and is largely automated. Second, any errors in calculating and paying the advances can be corrected by means of the after-the-fact settlement. Finally, legal rules and regulations for determining advances are few in number, and it is therefore relatively easy to act in accordance with them.

Evaluation of costs and definitive determination of the contribution

Activities of the Ministry

As mentioned, the municipalities actually execute the National Welfare Act; the Ministry only acts as supervisor/paymaster. With the aid of certain instruments, the Ministry can determine if the municipality has met the requirements of the various laws and regulations. The instruments used include:

- supervision and control by the state consultants, resulting in a standard report for each definitive cost statement submitted by the municipalities;
- control by auditors working with the municipalities, resulting in an auditor's report that accompanies the definitive cost statement.

On the basis of the information derived from these control procedures, the Ministry can determine the definitive contributions. It is important to realise that the control procedures are crucial. It is only because the Minister has them that he or she can account to Parliament for the expenditure of the money provided by the Ministry to the municipalities. Before determining the definitive contribution, the Ministry has to be well informed about the municipalities' actions. This means that many questions have to be answered:

- Are the municipalities authorised to do what they did on the basis of the National Welfare Act?
- Are the benefits granted by the municipalities on the basis of the National Welfare Act paid to those who are entitled to them?
- Did those entitled to benefits receive the right amount from the municipalities?
- Was a definitive cost statement accompanied by an auditor's report received from all eligible municipalities?

- Are the definitive cost statements filled in completely and correctly and have they been properly authorised by the municipality?
- Are the advances and settlements accounted for properly and promptly in the definitive cost statement?
- Do the expenditures included in the definitive cost statement actually fall under the National Welfare Act?
- Have all revenues, such as reclamation of incorrectly paid benefits, been accounted for properly by the municipalities?
- Is there mention of revenues, such as claims, owing to improper action or negligence on the part of the municipalities?
- Is the content of the auditor's report that accompanies the definitive cost statement favourable, and are there no additional comments that detract from a favourable judgement? If the auditor's report is not favourable, have appropriate measures been taken?

The Ministry answers these questions on the basis of information from the state consultants and the municipal auditors.

The control on how the contributions are spent and their definitive determination carries many risks, largely owing to the complexity of the law and its sensitivity to abuse and misuse. In addition, variations from one municipality to another in the administrative arrangements for implementation further complicates the ministry's task.

Role of state consultants

In order to be able to supervise the implementation of the National Welfare Act by the municipalities, the Minister of Social Affairs and Employment has appointed 180 state social security consultants. They work in offices across the country. They are trained on the job; some are lawyers, others have a degree in public administration. Their most important tasks are:

- checking the municipalities' implementation of the National Welfare Act;
- alerting the Ministry to important developments to which it should react promptly;
- carrying out policy discussions with the municipalities;
- handling external co-ordination with other institutions associated with the National Welfare Act to a greater or lesser degree.

On the basis of their work instructions, the state consultants evaluate how well the municipalities implement the law and determine whether decisions made by the municipalities correspond to the applicable rules. They conduct such studies annually for each municipality. First, they carry out a desk or office study based on the written information sent to the Ministry. The results of this study determine which municipalities will be subjected to further investigation.

The results of the desk study and any further studies give rise to a standard report which accompanies the definitive cost statement for each municipality. In addition, state consultants provide recommendations which may be aimed specifically at one municipality, but may also be of a general nature. Whether the municipalities comply with legal and regulatory requirements in implementing the Act is a central point in the reports of the state consultants. (I, para 24) As already mentioned, there is great risk of abuse and misuse. Estimates of the level of fraud in the system vary widely. In 1993, figures based on several studies varied from 7 to 25 per cent of expenditure. The Act and the Ministry's regulations point out that the municipalities should make great efforts to avoid misuse and abuse and that if they do not do their job appropriately, their allowance will be reduced. Also, those who seek to defraud are subject to sanctions. The municipality can cut their benefits and even stop them; the money received fraudulently must always be repaid.

In addition to these annual reports, which are essential to the final determination of the contributions to be provided to the municipalities, the consultants also compile an annual report describing any and all notable developments and bottlenecks in executive practice to be used for evaluating and, if necessary, adapting policy for the National Welfare Act. (I, para 38) These reports also enable the Minister to respond to reactions from Dutch society.

Finally, the state consultants carry out on the *ad hoc* studies, on topics generally determined by the Ministry, which examine specific facets of the implementation of the Act. They also submit an annual plan proposing their activities for the coming year.

Verification by the municipal auditor

The Ministry needs to know whether the municipalities follow the proper procedures and correctly process the finances in their administration, since the procedures followed are the basis of the definitive cost statement. The Ministry does not verify this itself. In the Netherlands, each municipality is constitutionally required to compile financial accounts annually and have these and the associated administrative procedures examined by an auditor who makes a report that is attached to the municipality's financial accounts.

For the Ministry, the manner in which the municipal auditors carry out this legally required control and report is naturally of crucial importance. The Ministry must be certain that the contributions provided to the municipalities through the National Welfare Act are spent properly; specifically, it must be certain of the accuracy (reliability, legitimacy) of the final cost statement. This is so important that the Ministry of Social Affairs and Employment has created additional regulations for checking the municipal auditor's control. The normal control, on the basis of the Council Law (law on local government), which defines the responsibilities of the local authorities, is not sufficient. These extra rules are set out in the National Welfare Act Control Protocol, which contains specific regulations for the National Welfare Act, and eventually results in an auditor's report that accompanies the definitive cost statement. As a result of these requirements, this control process on the part of the municipal auditor has become part of the management control and internal controls of the Ministry of Social Affairs and Employment.

The municipal auditor's report that accompanies the definitive cost statement is based on a study of the municipality's management control and internal controls, its administrative arrangements, and the frequency of the municipality's investigations of individuals' rights to benefits, among other things. The question of whether the municipality has properly followed laws and regulations has already been answered for the Ministry by the state consultants.

Definitive settlement of contributions

The Ministry of Social Affairs and Employment evaluates the definitive cost statements submitted by the municipalities on the basis of the reports of the state consultants and the municipal auditor. For this, it uses a standard list of questions. If there are irregularities or uncertainties, the cost statement may be subjected to correction or additional steps. The appropriate action is defined in detail in an official policy document, which all municipalities are aware of.(I, para 38)

The definitive contribution is processed in the financial administration department of the Ministry.(I, para 54) For this, the following actions are taken:

- the municipality is informed;
- the relevant advances are transferred out of the special account maintained for this purpose;
- the difference between the definitive cost and the advance is paid or reimbursed;
- the payment or the claim is processed in the financial administration.

In addition, conditions may be imposed. For example, if the state consultant has found deficiencies in a municipality, this may mean that the definitive cost statement is allowed, but the municipality in question is told to change its actions in certain respects. This must be followed up. If the municipality does not co-operate, a part of the contribution may be reclaimed at a later date, for example when the definitive cost statement for the following year is calculated. In 1994, the Ministry took such measures in 65 cases. The contribution to the municipalities concerned was cut by about Gld 10 million (0.1 per cent).

The departmental auditor's review

The departmental audit service (internal audit serving the Minister) audits the Ministry's accounting system annually and prepares a report to accompany the Ministry of Social Affairs and Employment's financial accounts. As a result of the work described above, appropriate entries are made in the Ministry's financial records, which are the basis of the Ministry's annual account, on which the auditor must report to Parliament. In order to judge the expenditures based on the National Welfare Act, the departmental auditor carries out the following work:

- Examination of budget implementation: Checking whether all incurred expenditures and receipts pass the test of legitimacy and whether or not the accounts are in accordance with regulations. Legitimacy is defined as the correct observation of all legislation in implementing the budget.
- Advances: The departmental auditor verifies that the Ministry has calculated the advances properly and that there is appropriate support. He or she then determines the extent to which the advances paid have been properly processed in the financial department.
- The definitive determination of payment: First, the departmental auditor evaluates the procedures and the quality of the work carried out by the state consultants. In addition, he or she verifies whether the state consultant and the Ministry have taken proper action with regard to improper actions by a municipality.

The purpose of this control is to confirm that the Ministry has made proper use of the work of the state consultants, that is, that the requirements of internal control have been satisfied.

The departmental auditor examines the work done by the municipal auditors both for the report for the definitive cost statement and as an internal control measure. The work of the municipal auditor is enormously important for the Ministry as a whole and essential for the departmental auditor in particular.

The departmental auditor examines annually the proper functioning of this internal control by carrying out reviews on a given number (around 10 per cent) of municipalities. This review consists of an introductory discussion, a study of the files, a closing discussion, and a report.

If the following requirements have been met, the normal review may be replaced by a "limited evaluation", which is carried out with the aid of a list of questions:

- A normal review study was carried out over the previous year and the findings were such that the departmental audit service could use the report of the municipal auditor in question without any additional action.
- There are no indications (for example on the basis of state consultant reports) that the situation in the year to be checked has changed or deteriorated.
- The contents of the report of the municipal auditor have been approved. (If a report is not approved, it is possible that the municipal auditor did not perform his work properly; the departmental auditor often demands more information on why a report was not approved).
- Findings from other verification procedures give no indication that the situation has deteriorated. This concerns both the review of state consultants by the departmental audit service and audits of established departmental procedures. The evaluation of these two processes is not primarily aimed at pointing out the weaknesses of the municipal auditor. However, indications of unusual situations may become apparent. It will then have to be decided if such matters justify a complete file review.

Based on the reviews and the "limited evaluation", the departmental audit service produces an evaluation of the soundness of the auditor's report submitted with the definitive cost statements and a procedural evaluation of the municipal auditor's work, which feed into its own evaluation.

In short, the departmental auditor determines the extent to which the municipal auditors abide by the legal and regulatory requirements in their audits. In addition, he or she must determine whether the report of the municipal auditors is a good reflection of their actual efforts. The departmental auditor also examines whether the municipal auditors have included all the findings relevant for the Ministry in their report and have indicated the repercussions of these findings.

Finally, the departmental auditor assesses the Ministry's actions with respect to the definitive statement of costs. A point of attention here is the extent to which the Ministry itself has followed the appropriate procedures. If deficiencies are observed, have appropriate measures been taken and has the definitive contribution been settled correctly?

The review by financial accounting is based on normal standards, of which the verification of advances and expenditures based on the National Welfare Act are a part. The two central questions are, first, whether the expenditures and receipts in the Ministry's financial accounts comply with the applicable laws and regulations and, second, whether they are in accordance with the Ministry's accounting system.

**CASES IN THE ROAD BUILDING PROGRAMME
(Germany)**

by
Dr. Detlev Sparberg⁶

Executive Summary

In the Federal Republic of Germany, management control in the government administration is a concern both of management itself and of the external audits carried out by the Federal Court of Audit (*Bundesrechnungshof*), which reviews the establishment and application of effective management control systems in the administration.

In the road construction administration, management control systems establish financial limits for all relevant decisions; additional authorisation is required whenever these limits are exceeded.

For the awarding of contracts, proper management control systems are crucial, as criminal activities in this area have recently increased. Our experience shows that there are three main types of manipulation which require firm management control: price fixing, changes in the results of competitive tenders, and collusion.

Work for government construction projects is awarded to the lowest bidder. If the bidders decide among themselves who is to submit the lowest tender, they undermine competition and deceive the contract-awarding authorities. Experience shows that, owing to price fixing, contract prices can exceed realistic market prices by up to 40 per cent. The administration is strengthening management control systems in order to prevent price fixing. The Federal Court of Audit is deeply involved in this process and devotes a considerable part of its work to this issue.

Before contracts are awarded, individual bidders often try to modify their offers. Germany has very detailed contract procurement regulations which establish how contracts are awarded. These rules make it possible to undertake management control during the procedure. Just recently, the Federal Court of Audit carried out a cross-sectional audit of public solicitation and contract-awarding procedures for construction projects. The audit disclosed various deficiencies in the procedures as well as in management control within the offices concerned. Up to 40 per cent of the offers had deficiencies that could greatly increase the danger of unfair competition.

Collusion means that the responsible civil servant in the contract-awarding authority and a bidder secretly co-operate to give the company a competitive advantage in the award procedure. In Germany, this form of illicit co-operation between planner and bidder has increased in recent years because planning in the field of construction has become more complex and has not been adequately monitored. Such

⁶ As Counsellor-Member of the Federal Court of Audit, the author is responsible for auditing road building expenditures in Germany. The views expressed are his own and should not be attributed to the Federal Court of Audit.

fraudulent actions can only be detected by specialists with a high level of technical expertise. Therefore, management control to prevent such practices becomes even more important. If strict adherence to all rules and regulations is enforced and supervised through management control, it will become much more difficult for the officials concerned to engage in collusion. In addition, knowledge that the risk of detection has increased prevents many employees from involvement in such criminal activities because of possible negative consequences.

Another crucial area with great financial impact is the settlement of invoices. These invoices contain an enormous amount of detailed calculation and require close scrutiny. In order to make errors and fraud as difficult as possible, the German administration has established several management control systems. The principles involved are not specific to the road construction business; they are generally the same in all administrations. The main management control principle here is the strict separation of responsibilities. In each case, at least two, and normally more than two, officials have to be involved, each with different and well-defined responsibilities. This makes it impossible for an official to make a payment without involving other officials.

Proper management control is important for the road construction business, and of course for other areas as well. Although a very good and comprehensive management control system is already in place in Germany's road construction offices, constant supervision is essential. This is, in the first instance, a management obligation. It is also in the interest of management, because a strict system, properly applied, is the only possible guarantee of the administration's trouble-free functioning.

1. Framework for management control in Germany

This section describes the main characteristics of Germany's management control structure. In order to provide a format that facilitates the comparison of practices in different countries, the introduction focuses on six basic areas.

Authority for management controls

In Germany there is no general responsibility for developing and promulgating standards for management control systems in government organisations. Each part of government and each government organisation is responsible for its own management control and for creating its own management control systems. However, given the structure of the German administration (described below), the main and decisive responsibility for developing and promulgating standards for management control systems in government organisations may be placed at a higher level of the administration.

Development and promulgation of management controls

Management control standards are not laid down in legislation. They may be defined by the administration concerned, depending on its level of authority. Because the German administration is hierarchical, the authority to make such decisions is divided among the different levels of the administration. Thus, management control systems can be established by some lower-level authorities within their area of responsibility, by a government organisation at a higher level for those administrations subordinate to it, or by a ministry for all the government organisations it supervises. Thus, the management control systems are defined by the administration concerned, either for its own use or for all subordinate administrations.

The hierarchical structure also influences the introduction of management control systems. A higher-level authority is usually in a position to instruct lower-level administrations to introduce specific management control systems and to supervise their application.

This system generally leaves the heads of government organisations sufficient flexibility to adapt the standards to their own management needs. To date, lower-level administrations have been free to add management control systems on their own initiative, and so far there have been no major complaints about lack of flexibility.

Role of the central agencies

The *Bundesrechnungshof*, the Federal Court of Audit (FCA), Germany's supreme audit institution, is not legally in a position to issue orders or instructions to the administration as a result of an audit. It verifies management control systems in its normal audits, and it may carry out specific audits in this respect. In the course of its audits, it verifies whether there are sufficient effective management control systems and whether they are applied properly. These audits also verify whether the administration itself is using its management control systems to monitor its own performance against the standards concerned. The FCA also verifies the application of various important standard accounting rules, the management of human resources, and the integrity of the automated data processing systems.

On the basis of the outcome of the audits, the FCA makes recommendations to the administration audited and/or the ministry concerned. The decision to follow these recommendations or not is up to the administration. In serious cases, when the recommendations are not followed, the FCA will inform Parliament either through its annual report or in a special report to Parliament or a parliamentary committee.

Generally, central agencies such as the budget office or the Ministry of Finance do not have more power in this respect than the FCA. They are more concerned with budgeting and accounting and less with actual work performance and the monitoring of performance through management control systems.

Adherence to INTOSAI Guidelines

Generally, the INTOSAI *Guidelines for Internal Control Standards* have been fully implemented by the German administration. Of course, there are always cases where management control systems are insufficient or not fully implemented. Some of these are presented below. However, to the knowledge of the FCA, there are no areas completely lacking in the management control systems required under the INTOSAI Guidelines.

Monitoring and evaluating management control systems

Management is the main user of the management control systems. Therefore, in the first instance, management itself has to monitor the performance of these management control systems. In addition, internal audits look into the application of the management control systems in the course of their audit. The role of the external audit carried out by the FCA is described above.

The FCA has no mechanism for overseeing the various management control systems in the German administration. In addition, it has no specific section responsible for questions of management control systems. Thus, each audit section is responsible for the management control systems in the administration it audits. However, on the basis of various audits, the general impression is that the management control systems in Germany are efficient and cost-effective as well. The FCA has not yet encountered really ineffective or expensive management control systems, and there appears to be no reason to criticise the administration in this respect.

Resources, skills, and training for implementing management control systems

Each administration has to ensure that managers and staff have the necessary resources, skills, and training programmes to operate effective management control systems. If there is a lack of staff, this has to be brought to the attention of the higher-level administration, which will bring it to the attention of the ministry concerned. If the ministry concerned is also of the opinion that more staff is required, it must include a request to this effect in the budget proposal for the following year. Training programmes are usually also the responsibility of the administration concerned. Various government institutions or private companies subsidised by government offer sufficient and efficient training for civil servants.

2. Germany's systems of control

The Federal Republic of Germany has two main levels of control with various sub-levels.

Administrative control

The annual budget estimates are the legal basis on which the administration manages estimated receipts and payments. In this way, the annual budget estimates place limits on the administration and enable the government, Parliament, and the FCA to control the administration.

Management control

The administration itself is obliged to supervise its own actions in its own interests. It does so first of all by management control. The main task of management control is to supervise the administrative regularity and legality. This is achieved by:

- Pre-audit or *a priori* audit: The pre-audit reviews administrative or financial acts before they take place. It means that all or certain acts require a countersignature by the head of the administration or his representative.
- Concurrent audit: This is the normal management control of the administrative management by which the administration supervises itself. It comprises financial aspects (execution of the budget estimates) as well as administrative or managerial features (execution of time schedules).
- Post-audit or *a posteriori* audit: The post-audit is an audit after the fact. It is mainly an effectiveness audit, a control of achievement, or a review of results. It is extremely important for the administration to know whether the results achieved are in keeping with the original or rescheduled planning, whether the activities at issue should be modified, and whether there is any empirical data for future use.

Internal audit

In most countries the internal audit is part of the management control system. It is a management tool for supervising the above-mentioned goals, in order to make sure that the administration is functioning properly. In the Federal Republic of Germany, the internal audit is part of the external audit. Although the internal audit forms an integral part of the activities of the administrative agencies, the internal auditors are only subject to the professional and technical guidance of the FCA. They only report to the FCA and may not take any other professional orders. Therefore, the internal audit in Germany is called a pre-audit, not in the sense of an *a priori* audit, but because it is carried out before that of the FCA.

The internal audit in the field of road building generally concentrates on financial or regularity auditing. After the central federal cash office has paid the invoices, they are collected and sent to the internal audit office concerned. The internal auditors check the invoices in their office or go on a field trip to the local office, normally once a year.

The internal audit is very important for the management because the internal audit report may disclose general deficiencies. However, as already noted, management is not in a position to use the internal auditors for management control purposes.

External audit

The external audit is carried out by the FCA, which is an independent government body responsible for examining government operations and transactions, for reporting on its findings, and for advising the executive branch on the basis of its audit experience. The expenditures to be audited by its audit staff of about 480 (about 410 auditors and 70 court members) amount to nearly DM 500 billion in 1995.

The Federal Court of Audit performs its audits with the help of the internal auditors, as mentioned above. But even with their assistance it is not possible to audit expenditures in a fully comprehensive way.

Political control

The budget estimates are discussed annually and agreed by Parliament. This enables Parliament to exercise political control over the government, since Parliament grants the funds that allow the government to carry out plans that require expenditures.

This political control is especially exercised by the Budget Committee. The FCA attends its meetings and advises this important committee on the basis of its audit experience. Another form of political control is exercised later by the Public Accounts Committee, a sub-committee of the Budget Committee. This committee, in which the FCA is entitled to speak, deals with the FCA reports.

3. Management control -- internal audit

Internal audit is often confused with management control. However, internal audit must not simply be equated with management control in government departments, or with entity control, which embraces all forms of operational or managerial control within an entity. Management control serves as a tool and managerial aid for senior management by providing assurance that business is being conducted in an orderly way.

Management control, efficacious though it may be, cannot replace the independent and comprehensive examination of the internal audit, which has to consider broader and more general issues. On the other hand, internal audit cannot replace management control. They have different goals and different ways to achieve them. Management control is more directed towards day-to-day control of routine operations and the efficiency and effectiveness of the work performed. In the German system, internal audit normally concentrates on cash audit and on verifying the proper rendering of accounts. For the audit of efficiency and effectiveness, there is usually little time available.

4. Importance of management control for the external audit

The FCA has comprehensive legal authority to audit federal financial management, so that there are no audit-free areas. However, complete audit coverage is practically impossible owing to the size of the Federal Republic's annual budget and the total number of civil servants, on the one hand, and the

number of auditors employed by the FCA, on the other hand, even if internal auditors, who assist the FCA in their audit work, are taken into consideration.

Even by using a sampling approach to auditing, the FCA is not in a position to cover the whole range of very different audit subjects. Therefore, this method does not allow for making a comprehensive statement about the correctness of federal financial transactions.

It is therefore necessary to reduce both the number and kind of audit topics. In accordance with the Federal Budget Code, the FCA can limit, at its discretion, the scope of the audit and refrain from auditing specific accounts. These audit reductions must not be applied arbitrarily, but properly and professionally.

Which audit reduction is proper? Which areas can be excluded from audit without potentially causing damage? The answer to these questions leads automatically to management control. The FCA can reduce its audit in those areas where it has assured itself that management control functions properly and is in a position to disclose possible errors and deficiencies in administrative actions. This is an indication of the great importance of efficient management control for the external audits carried out by the FCA.

The FCA deals with management control in two ways. First, it uses its influence to make sure that all rules and regulations concerning the work of the public administration also contain management control provisions. This is possible because, in the German system, the FCA has to be consulted before administrative regulations concerning the implementation of the Federal Budget Code are passed; and, whenever expenditures are concerned, this code is normally involved. This important regulation enables the FCA to become involved at an early stage and possibly prevent unacceptable decisions.

Second, as part of its regular audits the FCA is concerned to verify whether the management control regulations are strictly followed. It also examines whether the management control systems should be improved or simplified.

5. Management control in the road construction administration

Legal situation of the road construction authorities

Before going into the details of management control by the road construction authorities, it is necessary to explain the legal situation of these offices and the whole road construction business in Germany.

When discussing roads, I refer only to federal trunk roads maintained by the federal government. Federal trunk roads -- federal autobahns and federal highways -- are designed to deal with long-distance traffic. There are also the local or community roads for local traffic, which are the responsibility of the states (*Länder*). The main difference lies in their financing. Federal trunk roads are, with a few exceptions, financed by the federal government (see Table 1). The others are financed by the states, cities, or communities, whichever is responsible. The manner of financing has, of course, an impact on the auditing. Since the FCA is responsible for auditing federal expenditures, it is in charge of the audit for federal trunk roads.

The issue of who pays for these major roads is relatively simple. More difficult is the question of who builds and maintains them.

Germany is a federal republic, that is, it is a constitutional union in which both the federation and the *Länder* are legal entities. Together, they form the Federal Republic of Germany. The German constitution declares the Federal Republic as the owner and builder of federal trunk roads and assigns it the tasks of building and developing federal autobahns and highways. In this field, the Federal Republic has legislative power, which is mainly laid down in the Federal Road Act and includes all legal matters, such as the classification, dedication, reclassification, and incorporation of the federal trunk roads and responsibility for construction, public use and special use, legal relations, and funding of these roads.

However, the planning, construction, and maintenance of federal trunk roads is the responsibility of the states concerned. In this respect, they act on behalf of the Federal Republic and are responsible for all administrative matters. This means that they establish an office or a system of offices for the construction and maintenance of these roads. In consequence, they bear the administrative costs for these offices and for salaries, etc. They also bear the costs of planning the roads, which can be quite substantial. The Federal Republic pays the actual construction costs, however, including material, acquisition of land, and labour costs, along with an additional lump sum of 3 per cent for material costs in the planning phase.

The *Länder* carry out their duties independently. The Federal Republic, here the Federal Ministry of Transport, however, is in a position to issue general rules and give orders in individual cases. This rarely happens, and the general rules are usually drafted in conjunction with representatives of the states. There are several committees consisting of experts representing the Federal Republic and the *Länder*, which discuss all problems in the road construction business and agree on solutions. The FCA is usually represented in these meetings and therefore in a position to give its input, based on audit experience, at an early stage.

This system offers certain advantages, but it also has some disadvantages. It is, of course, very tempting for the *Länder* to use federal money to build, for example, more lavish bridges and noise prevention walls, which are very popular in Germany, than they would if they had to pay for them with their own funds.

Table 1. Tasks and responsibilities in road construction for federal trunk roads

Road class	Property and financial obligation for construction and maintenance		Administration	
	Rural highway links	Cross-town links	Rural highway links	Cross-town links
Federal autobahns	Federal government	-	<i>Länder</i> on behalf of the federal government	-
Federal highways		< 80 000 inhabitants Federal government		< 80 000 inhabitants Federal <i>Länder</i>
		> 80 000 inhabitants Local authorities		> 80 000 inhabitants Local authorities

The system through which the *Länder* act on behalf of the Federal Republic has consequences that are relevant to FCA audits. As the road construction offices are not paid for by the federal government, the FCA is not in a position to audit their administration, including its efficiency and effectiveness. It can only criticise the administration if it finds a negative impact on federal expenditure. The audit of other aspects is the responsibility of the *Länder* courts of audit. However, their primary interest is, of course,

to keep *Länder* costs as low as possible; it is not to spend less federal money. So when the FCA audits management control in the road construction offices, it encounters certain difficulties.

Planning

In the field of road building, planning is of special importance, not only as regards the roads themselves, but also in respect of the expensive related construction involved, such as bridges or tunnels. During the planning process, important decisions are made about the final cost of the roads. The FCA has traditionally favoured control by the road construction administrations of their own planning activities.

The road planning procedure has a built-in system of management control, owing to the limits established for planning authority. Generally, the lowest-level construction authorities in the *Länder* are responsible for the planning of federal roads. In the past, the road construction administrations have normally performed this task with their own staff. However, recently, especially in the new *Länder*, where there is little manpower and expertise, the offices tend to award contracts for planning to external engineering firms. The product delivered by external experts is then further processed in the office like other planning documents.

These offices have a system of limits of authority and a principle of double checking and double signature. Only simple and inexpensive decisions are taken by the lower-level officials themselves. Normally, their decisions have to be checked and approved by their superior or even the head of the office.

Up to certain limits, the lowest-level authorities can carry out the planning on their own authority. If the limit is exceeded, a higher authority has to examine and approve the planning, again up to certain limits. If these are also exceeded, the next hierarchical authority, normally the *Land* (state) ministry, has to be involved. The limits vary, according to the kind of project to be planned and the *Land* in which it is to be situated. In addition, the Federal Ministry of Transport has established further limits, and if these are exceeded, the federal ministry has to be involved. Table 2 shows the limits beyo which higher approval is required.

**Table 2. Levels of authority for checking and approving preliminary designs
Federal Ministry of Transport**

Project	For approval
Construction, extension and improvements of federal highways (design) with total cost exceeding:	DM 20 million
Construction of bridges (class 60/30) with a total span (measured along the axis of the route crossed) exceeding:	50 meters
Construction of tunnels with an interior length exceeding:	80 meters
Construction of further civil engineering structures (e.g. trough structures and retaining walls) with total cost exceeding:	DM 5 million
Repair, reconstruction and reinforcement of road pavement exceeding:	DM 5 million
New accessways for existing federal autobahns and federal highways with dual carriageways:	Always

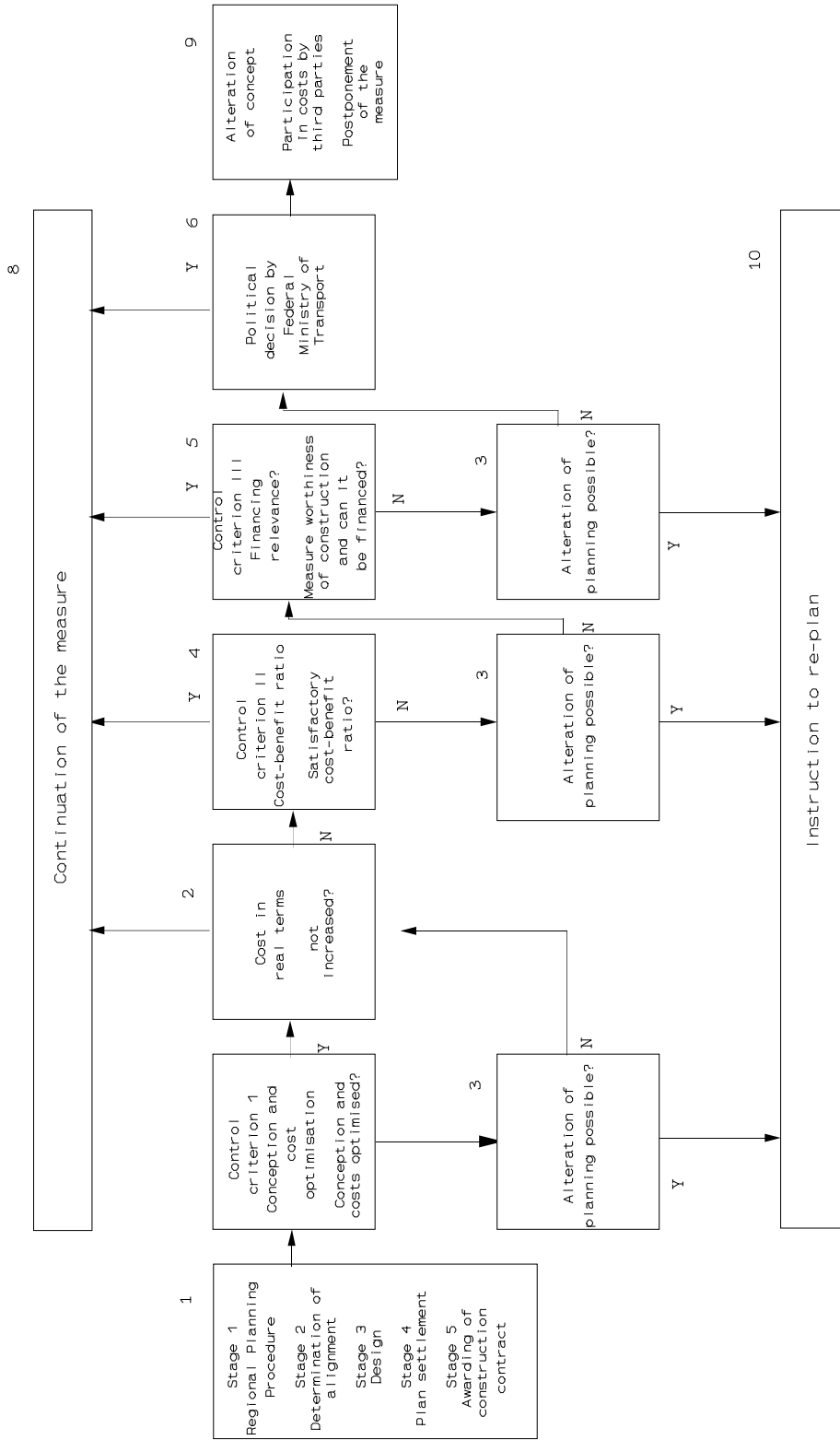
This built-in management control system is meant to ensure that no excessive or unnecessarily expensive constructions are planned and that the roads are to be built in the most efficient and cost-effective way. This is extremely important today, as the federal budget for new road construction is becoming tighter and the list of roads to be built is becoming longer. At the same time, the resistance of nature conservationists to new road construction is increasing steadily. They are requesting expensive tunnels or equally costly detours, or, at the least, extensive noise protection walls and, occasionally, but more and more often, special tunnels or bridges for animals.

In its audits, the FCA has found this management control system to have several weaknesses. Very often the lower-level administration deliberately underestimates the cost of the planned project in order to stay below its authorised limit. The higher authorities learn about this procedure, if at all, only when it is too late to change things.

The FCA is also of the opinion that these limits do not take into consideration the fact that smaller projects can also involve a substantial waste of money. In one case, it revealed and criticised the building of a small pedestrian bridge for a total of nearly DM 5 million, although a bridge sufficient for this purpose would have cost only about DM 0.5 million. As the sum was below the limits established by the ministry, the project did not require permission from the latter. This sort of problem could be avoided by establishing relative instead of absolute limits. The Federal Ministry of Transport would have to calculate average costs for various types of construction and request a presentation of those projects exceeding these average costs by a certain percentage. This matter is still under discussion.

As a result of its audits the FCA has often criticised the Federal Ministry of Transport for not always following the principles of efficiency and economy when approving major projects. Meanwhile, the ministry has realised the importance of cost management and has just recently introduced a new cost management system (see Figure 1 and Table 3). Its purpose is to introduce a uniform way of checking all projects concerned in the ministry. It is a tool within the ministry for achieving a better cost overview and better cost awareness in order to prevent, at an early stage, the construction of excessively costly projects.

Cost Management
Flow diagram of project cost checking in the Directorate-General for Road Construction



Source: Federal Ministry of Transport, Directorate-General for Road Construction

Table 3. Summary of the cost controls of the Federal Ministry of Transport

Field 1	Cost control generally takes place at each stage of planning. Each stage has a different time for the control.
Field 2	Control criterion I The type and number of control criteria depend on the status of the planning concerned. Conception and cost are to be optimised for the activities of the five stages.
Field 3	Repeating control questions, each time increasing the importance of a cost reduction.
Field 4	Comparison of the actual cost of the project concerned with the cost in the requirement plan and with the cost at the last project cost check, taking into consideration the overall evolution of the construction costs. Each time the cost exceeds the index, intensive cost control is required, especially for projects with cost increases that exceed the general cost increase by more than 5 per cent.
Field 5	Control criterion II Controlling or establishing the actual cost-benefit ratio, taking into consideration the increased cost and possible change in use.
Field 6	Control criterion III Projects with an inadequate cost-benefit ratio and for which the cost cannot be improved through replanning require additional verification to determine whether they are still worth building. For this decision, detailed and precise criteria are established.
Field 7	Those projects considered not worth building are subject to political decision (see Field 6).
Field 8	If the project is to continue, the ministry gives its approval to the <i>Land</i> concerned.
Field 9	Shows possible decisions as a result of the political review.
Field 10	Ministry's instruction to replan in order to reduce the cost.

It is planned to carry out these project cost checks for all projects subject to the ministry's approval. According to Section 7 of the Federal Budget Code, "cost-benefit analyses shall be carried out for suitable measures of considerable financial importance". The Federal Ministry of Transport is applying this principle to all road construction projects. It will verify whether the planned goal can be reached economically, efficiently and effectively, whether it requires modification, and whether the project should continue. The Ministry is well aware that this type of management control, based on the principles of economy, efficiency and effectiveness, is a permanent task.

Contract awarding

This is an area where good management control is crucial. For many years, the FCA felt certain that its system of employing civil servants with good salaries and very safe careers would make us relatively immune to fraud and criminal manipulation. However, especially of late, it has become apparent that this is unfortunately not the case. My audit section has started to co-operate with the Federal Cartel Authority and various criminal investigation departments in order to combine our different experience and capabilities. The FCA does not have the right to audit a private company to which a contract has been awarded. It can only examine the files in the local construction offices, which often do not reveal evidence of fraud. The files of the private company concerned have to be checked and compared as well, and although the criminal investigation departments have this authority, it is rather difficult for them to investigate the offices. The co-operation is therefore mutually beneficial.

Because these criminal activities reveal system deficiencies, our discoveries should lead to improvements in the management control system. This is an ongoing process. We issue our reports, which include observations and suggestions concerning the improvement of management control. It is only years later, when we return to the same office in the course of another audit, that we can verify whether the office has in fact improved their systems.

Our audit experience suggests that, in this area, there are three main types of manipulation that require firm management control:

- price fixing;
- changes in the result of competitive tenders;
- collusion.

Price fixing

Work for government construction projects, whether for the construction of buildings or roads, is awarded to the bidder submitting the lowest tender on the basis of open competition. If the bidders decide among themselves who is to submit the lowest tender and at which higher prices the others are to submit their bids, they undermine competition and deceive the contract-awarding authorities. Experience shows that such price fixing may result in prices that exceed market prices by up to 40 per cent. Under German law, price fixing is prohibited, and such illegal practices are prosecuted and penalised.

It is nearly impossible for the tender award body to find out whether prices are fixed in this manner, as market prices fluctuate widely and bidders conceal price fixing by setting the prices that exceed the agreed lowest bid at random. Price fixing is usually only disclosed through insider information, for example by dissatisfied company employees. This was the case for a recently discovered pricing cartel of large companies that produce air-conditioning equipment. These companies were fined DM 50 million by the Federal Cartel Authority.

The contract-awarding authority can only prevent price fixing by avoiding a situation in which there is a limited number of bidders. A public invitation to tender is the only effective remedy, as it allows any company to bid for the contract. Moreover, the tender award body has to ensure that bidders do not get into contact through the supplier of a specified product.

My office has recently reviewed, nation-wide, contract-awarding practices in the field of traffic sign purchases, road marking works, and protective crash barriers. For these items, the federal government spends more than DM 400 million a year. We learned that only about one-third of all contracts were open to full competition, and that a small number of companies dominate the market. We have urged the *Länder* to improve their contract-awarding practices significantly. This necessarily implies strengthening management control in the offices.

First, the system for awarding contracts should be improved to make it more difficult or even impossible to award contracts without appropriate competition. This could be achieved by requiring approval for such contracts from a superior or a second person; alternatively, contracts could be awarded by a special contract award committee. If all contracts underwent such review, inappropriate practices would at least be detected quickly and further violations could be prevented.

Second, the persons involved in awarding contracts should be transferred periodically to other offices or at least to other responsibilities within the same office. In several cases, the criminal connection between the official responsible for awarding the contract and the bidder developed over several years. Regular rotation would help prevent the formation of such links.

There are initial signs of major improvements since our report was issued. This year we are carrying out a control audit to look into the effects of our audit report on management control in this respect. We hope to find improvements in these systems which lead to improvements in contract-awarding practices.

Changes in the results of competitive tenders

After the solicitation period has expired and before the contract is awarded, individual bidders often try to change their offer. A bidder who does not submit the lowest tender may attempt to reduce his bid in order to obtain the contract. On the other hand, a bidder who submits the lowest offer may try to alter his bid by raising his total offer so that it almost equals the second lowest bid. Neither of these practices is allowed; they are anti-competitive and, in the long term, damaging to the Federation. Engaging in them can result in prosecution for fraud and falsification of documents.

Germany has very detailed contract procurement regulations which establish how contracts are to be awarded. The contract procurement procedure extends from the collection of bids from bidders to the awarding of the contract to the successful bidder. These procedures define, for example, which details the tenders must contain, how the unopened envelopes containing the tenders are to be treated, how the opening procedure is to take place, and how the tenders are to be checked and evaluated.

These rules also enable various management controls to be exercised during the procedure. When the tenders are opened, checked, and evaluated, a record must be kept of the proceedings. Thus, it is possible to monitor how well the actual awarding of the contract complies with the legal requirements. In some *Länder*, the responsibility for some parts of the contract-awarding procedure has been delegated to a special section which deals mainly with the formal requirements of the opening of the tenders. A check list has been developed as a management control tool; it contains several questions designed to determine whether or not the procedure has been followed correctly.

Just recently, the FCA carried out a cross-sectional audit of the procedures for public solicitation and awarding of contracts for construction projects. The audit disclosed various deficiencies in both the procedures and the management control within the offices.

The FCA audit showed that up to 40 per cent of the offers had defects which might greatly increase the danger of inadmissibly thwarting the competitive principle. For example, some offers contained a blank form instead of a description of services, and in others, the description contained blank pages. In some cases, the tenders had no entries for the requested standard prices, so that it would be possible to fill in prices afterwards. Occasionally, offers were kept in unlocked offices without supervision; thus, unauthorised persons could have access to the offers and modify or at least take note of their contents. Sometimes unauthorised persons had access to the machine for marking the offers at the bid opening date and could therefore mark other documents as well. Often, bidders had presented supplementary offers and referred to them in their covering letter, yet these supplementary tenders were neither mentioned in the bid opening procedure nor recorded in the minutes.

All these shortcomings, while they may appear unimportant and petty, can easily lead to manipulation of the competitive procedures and may have serious negative financial impact. We found, however, that the administration normally is not sufficiently aware of the importance of management control in this respect. Only with constant management control is it possible to enforce the application of strict bidding principles, and observance of these rules is one of the most efficient methods of preventing manipulations in this area.

In order to avoid such fraudulent practices, the FCA directed the administration to keep tenders locked away until the contract is awarded and to monitor closely the officials in charge. Moreover, the principle of investigating any changes in the ranking of tenders between the date of submission and the date of award was introduced. As a result of the audit reports, the FCA expects to see improvements in this area.

Collusion

Collusion means that the responsible civil servant within the contract-awarding authority, or an external engineering office acting on its behalf, co-operates secretly with a bidder to give the latter a competitive advantage in the award procedure. For example, planning may be tailored to a specific company, incorrect quantities may be deliberately stipulated, or certain specifications may be purposely left out. As only one company is aware of this, it can make allowances in its cost estimates and thus submit a lower bid than its competitors. In one case, a certain diameter of pipe, specified in the bid documents, did not correspond to the plans. The informed bidder was then able to offer a very low price for this item, since he knew it would not be used.

In Germany, this form of illicit co-operation between planner and bidder has increased in recent years because planning in the field of construction has become more complex and has been inadequately monitored. Such fraudulent activity can only be detected by specialists with a high level of technical expertise. Since those who engage in this practice have found ever more clever and diverse methods, it has become increasingly difficult to find evidence of its occurrence.

Management control designed to prevent such practices is therefore more and more important. Responsibility for the different steps of a construction project -- planning, invitation to tender, awarding of contract and the execution of the work -- should be given to different officials. At each step, it should be verified, if necessary with the help of check lists as mentioned above, whether the contract procurement procedures, including the contract-awarding principles, have been strictly followed. In this way, criminal collusion becomes considerably more difficult, as the danger of being detected at the next or any of the following steps is high.

If management control is used to enforce and monitor the strict application of all rules and regulations, it will become very difficult for the officials concerned to co-operate in a criminal way. In addition, the knowledge of increased risk of detection and the possible negative consequences will prevent many employees from engaging in illegal activities.

Financial management

Another crucial area with high financial impact is the settlement of invoices. These invoices, which contain enormous amounts of detailed calculations, have to be scrutinised and paid. In order to make errors and fraud as difficult as possible, the German administration has established several management

control systems, the principles of which are not only valid for the road construction business; they are very similar in other administrations.

Whenever an invoice arrives, the official in charge has to verify it. In the first instance, this is generally the site supervisor, who compares the measures in the invoice with those in his records, which he maintains and updates throughout the construction process. He also compares the prices given in the invoice with those quoted in the contract. His superior then reviews this, according to the rules of limits of authority. After any errors have been corrected and the final amount modified if necessary, the person authorised to do so signs the invoice, thereby indicating that it is factually and technically correct. This is a prerequisite for disbursement.

After the invoice has been certified to be factually and technically correct, it is sent to the financial management office in the road construction office. The financial management officer is head of this office and responsible for correct execution of the budget. He and his staff, again on the basis of limits of authority, verify the invoice in various ways. The invoice must have been certified as factually and technically correct by the person authorised to do so, the calculations must be correct, and the amount to be disbursed has to be within the limits of the amount committed. If all this is correct, the financial management officer signs the invoice and confirms that it is financially and arithmetically correct.

Only then can the invoice be sent to the federal cash office for disbursement. The cashier must ascertain that the document contains all the necessary signatures of the persons responsible, according to the different authorisations involved. For this purpose, he has a list of all these persons, with their responsibilities and signatures.

The main management control principle in this final step in the execution of the project is the strict separation of responsibilities. In each case, at least two, and normally more, officials must be involved, each with different and well-defined responsibilities. This makes it impossible for an official to undertake payment without involving other officials.

6. Conclusion

The above presentation shows the importance of proper management control for the road construction business and, of course, for other areas as well. Although the German road construction offices already have a very good and comprehensive management control system, permanent supervision to ensure that the rules are strictly followed is crucial. In the first instance, this is a management obligation. It is also in the best interests of management, because a strict system, properly implemented, is the only possible guarantee of trouble-free functioning of the administration.

In Germany, internal audits generally do not cover management control. It is therefore essential for the external audit body to concentrate on the efficiency of these systems and include this area in its audits. The issue is very often neglected in the course of normal audits, not because of lack of interest, but because of the limited time available and the extent of the tasks involved in the audit. The FCA has to examine the high level of expenditures, as well as the wealth of technical, juridical and environmental problems that are raised by the road construction business. Nevertheless, auditors' attention must be drawn to the importance of management control and the need either to carry out special audits on this topic or at least to include it in their regular external audits.

**CASES IN THE AGRICULTURE ADMINISTRATION
(Denmark)**

by
Rolf Elm-Larsen⁷

Executive Summary

This paper brings out two aspects of management control which are illustrated by the Danish administration of agriculture expenditures. First, management control is a means of regulating the influence of special interest groups on the implementation of (agriculture) policies; one of the cases described reveals inadequate management control on subsidy payments for bulls and steers in an EU programme where delivery was delegated to the national administration. Second, it indicates the problems involved when the administrative systems have several levels, such as the agriculture policy of the European Union, (the Community level, and the national level); the problems involved are illustrated again through the case of bulls and steers and through the case of Denmark's market intervention warehouses.

Denmark's management control system is a very flexible system, one that is suitable for delegating management control responsibility to the individual governmental agency. The Danish agriculture administration has three levels. The first is political and consists of the minister and the department. The second is administrative, composed of four executive agencies. The third level is that of the agriculture research institutions. A special feature of the Danish agriculture system is its close relation to agricultural interest groups.

In Denmark, agriculture administration is subject to the EU's market arrangements and national structural arrangements. Some aspects are delegated to agricultural interest groups. Within each of these administrative areas, the Auditor General has reported inadequate or ineffective management control systems.

When programmes are legally subject to more than one level of administration (e.g. EU and national) the objectives and concerns of the two levels may differ, and therefore their expectations of the management controls may not coincide. Management controls should be designed so that they do not create conflicts of interest between the different levels. They should also work to prevent interest groups from unduly influencing the public administration.

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1. Introduction

The aim of this paper, essentially based on Danish experience, shows what can be learned from an audit of management control in the administration of agriculture; it seeks to contribute to the development of best practice in the administration of this sector.

As used here, the concept of management control is that of the INTOSAI *Guidelines for Internal Control Standards*, later expanded in the framework of auditing co-operation within the EU.¹ The audit institutions of the European Union have issued implementing guidelines for use in audits of European activities; these are designed to make the INTOSAI auditing standards for management control more operational.

Through examples drawn from the work of the Danish Office of the Auditor General, this paper shows how audits have revealed weaknesses in the management control systems in the area of agriculture. It also indicates the risks involved when management controls are weak or absent. The cases described highlight the importance of management control in regulating or modifying the influence of special interest groups on the implementation of (agriculture) policies. Second, they show the importance of management control in multi-level administrative systems, notably when both the European Union (EU) and national structures are involved.

A short introductory presentation of certain aspects of the administrative structure for Danish agriculture is designed to situate the examples in their administrative context. Danish agricultural policy has two main pillars, EU market arrangements and structural arrangements. A particularity of the Danish system is the delegation of administration to special interest groups.

2. Framework for management control in Denmark

Authority for and development of management control procedures

Under the government's Accounting Act, which specifies the institutional framework for developing and providing accounting regulations and standards, Parliament has authorised the Minister of Finance to stipulate the rules of government accounting. It is therefore the responsibility of the Minister of Finance to develop the principles of government accounting practice, including management control. The Minister of Finance has thus issued rules instructing the different ministries and government agencies to set up their own regulations for each organisation's accounting practices, including management control. On the basis of these general principles, each ministry or government agency must develop its own rules of accounting practice and management control and is obliged to implement them.

The Accounting Act and the regulations issued by the Minister of Finance are published in the Danish *Official Journal*. The rules governing the individual ministries and government units are public, in keeping with the Danish Freedom of Information Act.

The principles on which the mandatory accounting practices and management controls in the Danish government sector are based are very flexible. This is necessary, as the regulations must be followed both by institutions with very complex economic tasks and structures and thousands of civil servants, such as the Ministry of Defence, and by government agencies with a simple structure, very few employees, and small expenditures.

On the one hand, it may seem dangerous to give the individual ministries the right to stipulate the rules governing their accounting practice.² On the other hand, the Auditor General's Office has

reported no empirical evidence of abuse on this basis. In fact, ministries and government agencies appear more inclined to follow accounting regulations that they themselves have established.

As the problem of fraud is a significant one for the European Communities' agriculture policy, it has received particular attention in terms of management control. As a result, the general European guidelines on management control (see Introduction chapter of this volume) include a supplement on standards for auditing irregularities stemming from fraud. To prevent irregularities and fraud, it is imperative that there should be effective management control both at Community and national level.

Role of central agencies

A government agency reporting to the Ministry of Finance provides accounting services for a large part of the government sector. At present, the Ministry of Finance does not monitor the implementation of government accounting practice and management controls. Each minister is responsible for setting up the necessary management controls and monitoring their effectiveness.

In its work, the Office of the Auditor General evaluates the effectiveness of management control systems. Important observations about missing or inefficient management control systems are reported to the Public Accounts Committee. The criticism contained in the audit reports suggests, to some extent, what best practice should be. For this reason, the Auditor General's reports, along with the remarks of the Public Accounts Committee, are widely circulated in the government sector. At the moment, no guidance on best practice has been explicitly formulated either by the Minister of Finance or by the Auditor General.

Comparison with INTOSAI guidelines

The general and detailed standards for management control contained in the INTOSAI Guidelines (I, paras. 4 and 5) have not been specifically incorporated into the Danish legislation on government accounting. However, most of the elements can be found in the legislation and in regulations on government accounting. The detailed standards (documentation, recording, authorization), in particular, are part of the government's accounting legislation and of government agencies' internal regulations on accounting procedures.

INTOSAI's general standards concern management's attitude towards management control (supportive attitude, integrity, and competence). They are, therefore, somewhat imprecise in nature, and it is difficult to identify them in the government's accounting legislation. In practice, they are used by the Auditor General when monitoring management control in Danish government agencies.

Monitoring and evaluation of management control systems

No special government unit is assigned to evaluate management control in Denmark. It is management's responsibility to evaluate the effectiveness of the management control system through its internal audit. This is clearly stipulated in the agreement on internal auditing made between the Auditor General and the minister in charge of the government unit.

Monitoring and evaluating the performance of management control is one technique used by the Auditor General's Office when carrying out the financial audit of state accounts.

In the area of agriculture administration, both the European Commission and the European Court of Auditors carry out evaluations of Denmark's management control systems.

Resources, skills, and training for implementation of management control

Denmark has no general arrangements for ensuring that management and staff have the necessary resources, skills, and training for operating effective management control systems. Instead, specific arrangements are made on an *ad hoc* basis in the largest government agencies. It is thought best to have specific arrangements suited to each government sector. Flexibility and cost effectiveness are also advanced as arguments for the decentralised training arrangements.

3. The Danish agriculture administration

Implementation of agricultural policy in Denmark takes place through close co-operation - both in relation to EU aspects and national farm policy - the Ministry of Agriculture (and its various agencies - see below) and farmers' interest groups.

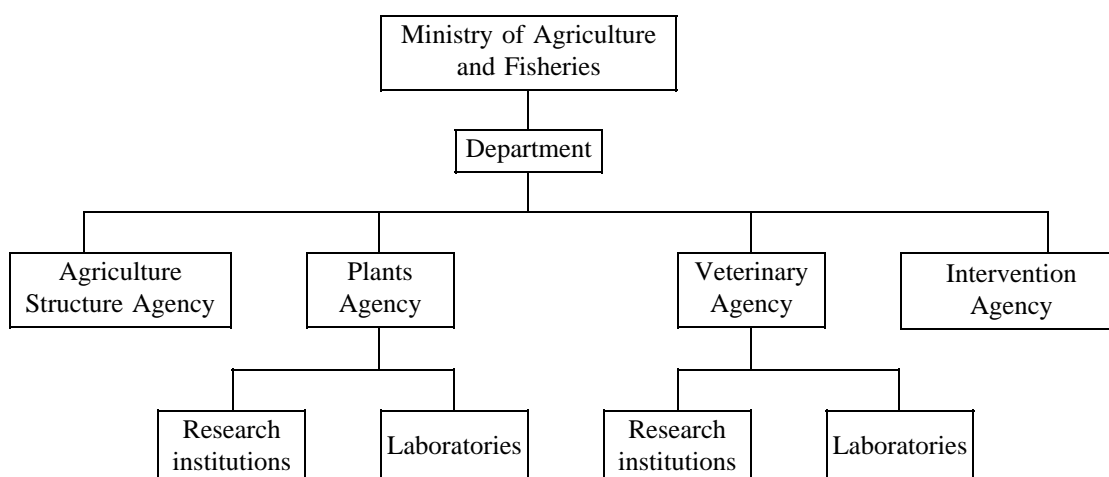
Ministry of Agriculture

The Ministry of Agriculture's main objective is to promote profitable production and turnover in the agricultural sector, as well as to ensure that farming activities take place within the framework set by the public authorities. It is the Ministry's task to carry out administrative and control functions for this area. In addition, it has responsibility for relevant international requirements for the sector, for business promotion, and for research and experimental activities.

The Ministry is divided into three administrative levels. The first is the political level, composed of the Minister and the small staff of the Department. The second is that of administration and management, tasks that are carried out by the operational organisations -- the Agricultural Structure Agency, the Veterinary Agency, the Danish Intervention Agency, and the Agricultural Plants Agency. The third level consists of the Ministry's research institutions and the diagnostic laboratories. The basic structure of the Ministry of Agriculture is shown in Figure 1.

The Agricultural Structure Agency's main task is to administer the subsidies and the regulatory laws aimed at activities that increase agricultural productivity, improve the quality of products, and develop new products and production methods. It also promotes activities that improve environmental and natural conditions in the countryside and encourage the adaptation and development of agricultural structures in agricultural districts.

Figure 1. Structure of the Danish Ministry of Agriculture



The main objective of the Agricultural Plants Agency is to ensure, through various control measures, that the quality of seed and grain is satisfactory and will benefit vegetable and animal production and exports, and meet the needs of consumers. Part of the agency's expenses are financed by the farmers and firms that use the Agency's controls services.

The Veterinary Agency is charged with ensuring the production of healthy animals, maintaining safe and healthful animal food for consumer purchase, and assuring proper control procedures for export of live animals and animal products. The tasks involving meat production and trade in live animals are financed to a large extent by the abattoirs and producers.

Both the Plants Agency and the Veterinary Agency have many research institutions and laboratories.

In Denmark, administration of the EU market arrangements for agricultural goods is the task of the Danish Intervention Agency, which calculates and pays subsidies from the European Agricultural Foundation (FEOGA); it also administers guarantees in the form of restitutions and market-regulated measures, including premium arrangements and arrangements for production and producer subsidies. In addition, the Intervention Agency purchases, stocks, and sells products included under EU programmes for market intervention.

The Danish Intervention Agency has final responsibility for planning and co-ordinating the management control for EU market arrangements. Implementation is mainly carried out by the Plants Agency and the Veterinary Agency, in co-operation with the Customs and Tax Office.

Special interest organisations

Danish agriculture has three farmers' organisations, which have joined together in the Agricultural Council. One of the latter's tasks is to promote agriculture's interests in Parliament, the government, and the central administration. Traditionally, agricultural special interest organisations in Denmark have had great influence on policy formulation for the sector, and they have assumed an active role in its administration. In specific areas, administration is delegated to farmers' interest groups under rules of administration stipulated by the Minister of Agriculture (see Section 6).

The influence or power of farmers' interest groups has been reinforced by the fact that medium-sized farms, which are the most numerous, have been and are closely connected to the Liberal party, a pro-European party with a liberal economic political profile. The small farmers' association has traditionally been tied to the Radical Liberals party, which for a number of years has determined the political balance in the Danish Parliament because it has been placed in the centre of the Danish political scene with its social-liberal ideas.

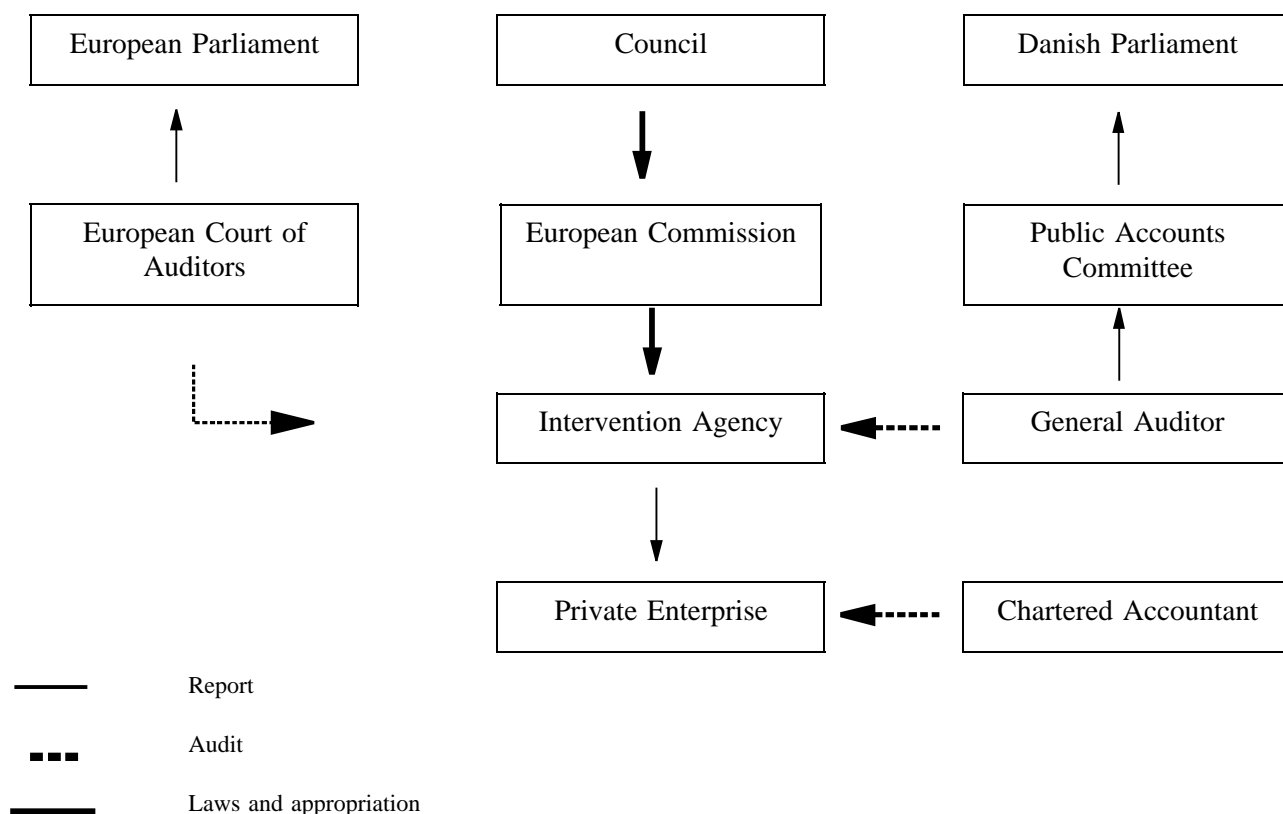
In theory, and as described, the system is one in which special interests and administration are two separate spheres. However, in reality, the system has many points of comparison with corporate democracy, which includes special interest groups in the process of policy formation and implementation. This has consequences for management control related to the administration of grants, supports and other expenditure on agriculture.

4. Management control in the administration of market intervention

Danish agricultural policy is part of the European Union's common agricultural policy, which has as one of its goals the stabilization of markets for agricultural products (EEC Treaty, Art. 39). To help attain this goal, a common European arrangement for markets for agricultural products was established; it includes provisions for such issues as regulating prices, support for both production and sale of diverse goods, stocking and payment arrangements, as well as common arrangements for stabilizing imports and exports (EEC Treaty, Art. 40).

The following two examples illustrate the difficulties of management control in the administration of EU market arrangements in Denmark.³ Figure 2 shows the audit system for the European Union's agriculture expenditures.

Figure 2. Audit of the EU Agricultural Intervention



Inadequate management control for premiums (subsidy payments) for bulls and steers

EU market arrangements for agricultural products are intended to provide a substantial degree of support for producers' income. This applies, for example, to the intervention mechanisms by which individual member states undertake support purchases when market prices in member states fall below a given intervention price level.

In 1987, the market arrangement for beef was changed, so that such purchasing would be initiated, not at the intervention price but only when the market price fell below the intervention price by a certain amount. To counterbalance the resulting drop in producers' income, a temporary premium arrangement for male animals was introduced for beef producers who kept bull calves until they had reached a certain age or weight. Member countries were given their choice of two models for calculating and delivering the subsidy; states could either receive the premium for live animals at least nine months old (the farm model) or for animals that had a slaughter weight of 200 kg (the abattoir model). The premium was set at ECU 25 per male animal (bulls and steers). Denmark chose the farm model. The premium was given for male animals that were at least six months old at the time of application, and which the producer pledged to keep on the farm for three months. This reference period was set due to the need to be able to verify whether the animals actually existed. The Danish Intervention Agency administered the programme, and verification checks were made by the Veterinary Agency.

In 1987 and 1988, the Danish Intervention Agency received about 33 000 applications, of which 31 800, concerning some 266 000 animals, were approved. The Veterinary Agency carried out 1 743 audit visits and found 564 violations of the agreement. The most frequent violations were absence of the

required individual identification of animals by earmarking; and sale of animals prior to the end of reference period or even prior to application. Thus, a third of the applications that were audited were rejected. Adjusted to the entire set of applicants, this indicates that about DKr 20 million in premiums were paid out in situations where the stipulated conditions were violated. Under EU regulations, these findings could result in annulment of the whole premium and refusal by EU of compensation for payments already made during the period when the legislation was not correctly implemented.

The Office of the Auditor General carried out a review of the management control system and found that the Ministry of Agriculture ought to have strengthened control and introduced legal sanctions in order to encourage proper application of the regulations. Furthermore, it found that the Ministry, when selecting the farm model, had not sufficiently evaluated the administrative consequences, including the control aspects, of the arrangement. The Public Accounts Committee called attention to the inadequacy of the controls and sanctions for administering the arrangement and criticised the Ministry's administration for risking loss of EEC subsidies.⁴

From 1989, Denmark changed over to the abattoir model, in which the premium is granted at the abattoir for animals that meet the stipulated weight requirements. This avoids the problem with the farm model which opens the possibility of payment being made several times for the same animal. On the basis of the earmarks, the abattoirs register information for each producer and send the Danish Intervention Agency information on the slaughter of animals entitled to subsidies. Since the abattoir model was adopted, the Veterinary Agency only checks whether individual producers have the capacity to fatten the relevant number of animals. In this arrangement, individual producers do not have to stipulate how many animals they wish to obtain premiums for.⁵

In February 1989, the European Commission asked the Agricultural Agency to forward the report of the Office of the Auditor General on the special premiums for beef producers. This was in connection with the termination of the 1987 accounts for the FEOGA guarantee. Furthermore, the Commission asked Denmark to explain why the number of control visits for the premium year 1987 had not been increased in light of the results of the control visits made. On the basis of the Danish authorities' reply, the Commission announced in 1989 that adjustments to the amount of subsidies would be made in the accounts for both 1987 and 1988. After further negotiations, the Commission confirmed its reduction in the subsidies, and Denmark did not bring the matter before an EU court.⁶

Denmark chose not to demand reimbursement from the beneficiaries for the erroneous payment of support, since it did not appear feasible, in practical terms, to do so. As a result, the Ministry of Agriculture was obliged to request from Parliament extra funds to cover these expenses.

Interpretation

The special interest groups in agriculture have a natural interest in a control arrangement which gives the greatest economic benefits to the largest possible number of their members as quickly as possible. To this end, the agricultural industry is willing to use its political and administrative influence. Although the programme in question was aimed mainly at beef producers, those farmers with economic interests in milk production are of special note. Among dairy herds, the Jersey cow is widespread in Denmark, and it is characteristic of the breed that male animals take a relatively long time to reach 200 kg. Thus, by choosing the farm model, the agricultural organisations could obtain the greatest support for their members. This also made it impossible to establish a sure basis for control; at the same time, there was no economic risk for those receiving support.

The Ministry of Agriculture had divided loyalties on this issue: on the one hand, it had responsibility for ensuring that administration of agricultural subsidies was effective and complied with the law; on the other hand, the Ministry was undoubtedly influenced by the special interest groups whose objective was to obtain the most EU funds possible. The Ministry had probably expected that there was limited risk that the accounts would not be approved by the EU, since EU control interventions are necessarily limited to random checks. Thus, the weak management control system for the farm model can be traced above all to the fact that the agricultural organisations had great influence on the Ministry of Agriculture's choice of model. At the same time, the Ministry's role was double: as administrator and control authority on the one hand, as supporter of the agriculture industry on the other. This cocktail makes for a bad framework for establishing effective management control systems.

Management control in the administration of intervention warehouses

The general design of EU market intervention programmes provides that the Member states are reimbursed for the following:

- the cost in relation to purchase of agriculture products;
- the cost in connection with storage in warehouses;
- the cost of selling the stored products.

The purchased agricultural product is taken into the inventory of the Intervention Agency at a book value which is reduced to recognise a deterioration in quality during storage. The difference between the purchase price and this book value is immediately reimbursed by the EU.

All costs in relation to the storage (loading, transportation, unloading, storage, reloading, outshipment) is refunded by the EU Commission. The Member states' loss of interest on the amount of money invested while the product remains in the warehouses is also compensated by the EU Commission.

Finally when the products are sold from the warehouses the selling price is related to the book value in the Intervention Agency accounts. If there is a loss on resale the EU Commission covers it and if there is a gain on the resale, that profit is credited to the EU Commission.

In a report to the Public Accounts Committee, the Office of the Auditor General presented its examination of the administration and control of the intervention warehouses for the EU programme in Denmark.⁷ This report contains an evaluation of internal controls on administering the EU market arrangements in Denmark. Part of the study was devoted to intervention in grain and beef.

The Office of the Auditor General observed by way of summary that the Danish Intervention Agency is ineffective, partly because it uses too few resources for control and partly because of delays arising from a continued failure to adopt electronic data processing. This observation upholds the explanation advanced by the Danish Intervention Agency for its inadequate dealing with special cases.

As examples of the lack of management control, there did not exist, for the grain sector, any real guidelines for dealing with individual cases. That meant, among other things, that the Danish Intervention Agency had accepted and bought quantities which substantially exceeded the quantities initially offered. The Danish Intervention Agency did not have any procedures for ensuring that the maximum limit for individual stocks could not be exceeded. In addition, there was no precise information about the destination at which grain was to be stocked, and therefore there was insufficient management control for expenses

occasioned by the transport of grain. Furthermore, significant inadequacies, in the form of double payment, were revealed in connection with the costs of moving stock into and out of the warehouses as well as stocking costs paid out after the expiration of the deadline for removal from warehouses.

In regard to expenses for cold storage capacity for stocking beef, there were significant price discrepancies that could not be justified by the differences in the quality of the stocking conditions. In addition, there was no clear basis for the individual price agreements for stocking beef in the cold stores. The stocking cards, which the Danish Intervention Agency filled out by hand, were not kept up to date, so that control of beef stocks was carried out on the basis of the cold stores' own lists of stock. Finally, the investigations showed that not all warehouse managers had submitted statements of accounts and, further, that submitted statements of accounts were not checked against the Agency's own lists of stocks. Thus, management controls for administration of intervention stocks for grain and beef revealed numerous deficiencies.

General remarks

Depending on whether a European or a national institution is involved, approaches differ for control of administrative procedures and for audit of funds used for intervention.

Audits of management control by the national audit offices are essentially designed to ensure that the national intervention agency is cost-effective and that turnaround on claims is as efficient as possible and results in minimal losses to the national budget.

Fulfilling the requirements of the European Commission and the European Court of Auditors involves a more detailed and demanding set of goals for management control. These two European institutions underline the importance of the administration's management controls complying with the Community regulations in all their complexity.⁸

The above-mentioned cases show the importance of establishing and implementing the necessary management control system. This is the only way to ensure the credibility of the administrative system.

5. Management control in the administration of grants for structural change

One of the objectives of the EEC Treaty (Art. 39) is to increase agricultural productivity by "promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour", in order to ensure the agricultural producers and their employees of a reasonable standard of living. In order to reach this goal, a common arrangement was set up for marketing agricultural products (EEC Treaty, Art. 40.2). To support the common market arrangement, one of several structural foundations for agriculture may be set up. Parallel to this, member states may also, within certain limits, grant state support to agriculture.

Productivity and effectiveness

Management controls should help ensure that the audited entity's business is carried out in an economic, productive, and effective way that guarantees that relevant policy will be implemented.

The following example concerns the Office of the Auditor General's investigation in 1994 into the productivity and effectiveness of the Agricultural Structure Agency in connection with the administration of two similar programmes: first, a part of the EU subsidy programme for promoting the adaptation of agricultural structures; and second, the national subsidy arrangements for product development in agriculture within the areas of foodstuff technologies and research and development programmes.⁹

The Office of the Auditor General calculated and compared the productivity of the two subsidy arrangements over time. To do so, it set the number of individual cases of subsidies against the costs of administering the arrangements. For the three years investigated, it was observed that productivity fell the first year, then rose in the following years. The study gives no reasons for the change in productivity.

In analysing effectiveness, an evaluation was made of the organisation's ability to act with speed, simplicity, and reliability.

Speed in acting on individual cases may be judged by the relationship between the nature and the duration of the action. The Office of the Auditor General's study showed, in certain cases, that actions extended over longer periods than would seem justified by the nature of the cases.

Simplicity would imply that treatment of individual cases is characterised by a lack of unnecessary formality. On this point, the study showed that cases had to be reopened several times prior to decision, because, for both of the programmes investigated, those seeking subsidies were required to forward supplementary material on several occasions.

Reliability was defined as the organisation's ability to identify, limit, and clarify the case so that it is decided correctly. Here again, it was observed that the Agricultural Council did not meet the requirements that should have been expected of it.

On the basis of the Office of the Auditor General's study, the Public Accounts Committee stated that the Agricultural Council's organisation could be severely criticised and requested the Office of the Auditor General to carry out a more detailed study.

The Office of the Auditor General's evaluation concerned whether the management controls of the Agricultural Structure Agency function effectively, so that there are no major deficiencies in the economy, productivity, or effectiveness of the activities being audited. After examining the system and making further in-depth studies of the Agency's management control, it concluded that administration by the Agency did not follow best practices of good public administration.

6. Management control for delegated administration of agriculture policy

Denmark has a long tradition of delegating the implementation of agriculture policy to interested organisations or other organisations outside the governmental hierarchy.¹⁰

Since the 1950s, a small tax has been levied on exports and other sales of agricultural products. The revenue was turned over to agriculture organisations through a system of funds to make money available for spending on a number of agricultural purposes. Some funds also received money from property taxes paid by farmers. Others were partly financed through government subsidies. In 1989, about DKr 1.2 billion or US\$ 0.2 billion were handled by the agriculture organisations under this administrative regime.

This system of funds was based on political deals made over the years between farmers' organisations and the Ministry of Agriculture. These agreements were always ratified by Parliament through law or budgetary decisions. There seems to have been no conflict between the Ministry of Agriculture and the special interest organisation concerning the management of the funds.

This system of delegated administration has been criticised by Christensen (see note 10) on the following grounds:

- goal displacement;
- unclear accounting practice and lack of financial transparency;
- further delegation of administration by the Agricultural Council to other organisations;
- blocking the Office of the General Auditor from access to subcontractors accounts.

The administration of agriculture policy by those to whom it was delegated appears not to have made use of procedures and other measures that would provide reasonable assurance of orderly, economical, efficient, and effective operations. It could not be documented that the delegated administration safeguarded resources against loss due to waste, mismanagement, errors, and other irregularities, or that it adhered carefully to laws and regulations (I, para. 3). The lack of proper management control produced heavy criticism from the Auditor General and the Public Accounts Committee.¹¹

On the basis of this criticism, the government was forced to appoint a judge to investigate the Ministry of Agriculture's delegation of responsibility. The purpose was to investigate the legal responsibility of the participants involved in the administration of the funds. After the investigation was completed, no further steps of a legal nature were taken to clarify or rectify these issues. Later, the Ministry of Agriculture was reorganised and management control was improved.

7. Management control as a political and social phenomenon

From the cases described above, it is possible to generalise about the importance of management control for preventing special interest groups from obtaining exclusive influence over the implementation of agriculture policy and the inherent need of management control in administrative systems with several levels.

Management control as regulator of the influence of special interest groups

The above cases bring out the importance of having the management control systems in place so as to protect against improper influence by special interest groups.

It is a characteristic of management in democratic government that decisions should not be dominated by non-objective considerations, including the special orientations of interest groups. Generally speaking, management control is a means of assuring not only a correct financial reporting, but also lawful and effective management in government.

From the Danish experiences it can be seen that the need for an appropriate management control system is most important if interest groups have power/influence in the initial determination of the policy or if they participate in the implementation of the policy.

When the administration has such a proper management control system then the risk of irregularities in the treatment of interest groups is minimized. This, in turn increases the credibility of the financial reporting of the administration.

For these reasons management control can be considered an essential brick in the construction of modern democratic government.

Management control in systems with several levels

Most of the cases discussed above concern an administrative system with several levels, a higher administrative level (EU or national) which designs, regulates and oversees the administrative system's main features and a second level whose role is implementation (national or special interest group).

The first level expects the second level to act in accordance with the objectives and rules of the administrative system which it has designed. The second level wants to ensure the credibility of its implementation of the administrative system and to this end creates management controls.

If, however, both levels act to maximise their own economic self-interest, the situation changes. There is then a risk of conflict of interest in administering management controls at the different levels. The second level will try to maximise economic benefits and minimise the cost of management control. Only if there is a risk of losing financial benefits will the second level have an interest in promoting effective management control.

The first administrative level, because it has less information, is in a weak position to evaluate the effectiveness of the second level's management control system. On the other hand, the first level governs the structure of compensation and could design it in a such a way as to reinforce management control by the second level,¹² including the use of both incentives and sanctions to improve performance.

Finally, when the EU is the first level and a national administration the second level, an interesting dynamic affects the SAI. The European Court of Audit is bound to act in support of EU goals and policies but it is dependent, for the most part, on the work of the national SAI. The SAI has to verify that the EU legislation is implemented in the Member state even though the national administration has an economic interest in interpreting the EU legislation to the best advantage of its country. The national SAI - in my opinion - has a duty to behave in accordance with professional standards even though it is a disadvantage to the interest of its own country in the short run. In the longer run such a behaviour creates a better point of departure for the Member states' negotiations within EU; the demonstration of a well functioning administration and highly professional auditing creates a base of credibility for the national negotiating position.

NOTES

1. *INTOSAI Auditing Standards. European Community Implementing Guidelines. For Use in Audits of European Community Activities. Authorised for Use on a Test Basis by the Contact Committee of the Presidents of the Supreme Audit Institutions of the European Community.* 29 September 1993.

2. This situation suggests the phenomenon of "regulatory capture", that is, the risk that regulatory industries in effect determine the information that the regulator requires of them, to detriment of consumer interests. David Mayston, "Financial Reporting in the Public Sector and the Demand for Information", *Financial Accountability and Management*, Vol. 8, No. 4, p. 323.

3. The problem is not unique to Denmark. In the United Kingdom, the National Audit Office reported that failures in different types of management control (management, accounting, and staffing) are considered to pose inherent risks, which could have material consequences for financial reporting and for compliance with the European Communities' regulations. National Audit Office, *Intervention Board for Agricultural Produce: Management, Accountability and the Prevention of Fraud*, HMSO, London, 1990.
4. Parliamentary Public Accounts Committee, *Beretning om sammenholdelse af bevillingen og regnskabstal i Statsregnskabet for 1987 (Report on the Comparison of Budgetary and Accounted Figures in the State Accounts for 1987)*, Copenhagen, 1989, pp. 51-53.
5. Parliamentary Public Accounts Committee, *Endelig betænkning over statsregnskabet for finansåret 1987 (Final Thoughts on the State Accounts for the Financial Year 1987)*, Copenhagen, 1990, pp. 60-61.
6. Parliamentary Public Accounts Committee *Endelig betænkning over statsregnskabet for finansåret 1988 (Final Thoughts on the State Accounts for the Financial Year 1988)*, Copenhagen, 1991, pp. 40-41.
7. Parliamentary Public Accounts Committee, *Report No. 13/92 on the administration and control of the E.U.'s Intervention Warehouses in Denmark*, Copenhagen, 1994.
8. Roger P. Levy, "Audit and Accountability in a Multiagency Environment: The Case of the Common Agricultural Policy in the UK", *Financial Accountability and Management*, Vol. 10 (1), February, 1994, pp. 65-75.
9. Parliamentary Public Accounts Committee, *Report No. 7/93 on the Agricultural Council's Productivity and Effectiveness in the Administration of Selected Areas of Subsidy*, Copenhagen, 1994.
10. Jørgen Grønnegaard Christensen, "Corporatism, Administrative Regimes and Mismanagement of Public Funds", Paper presented at the ECPR Joint Sessions Workshop on New Forms of Public Corruption, Leyden 1993.
11. Parliamentary Public Accounts Committee, *Beretning om finansierings-, afgifts- og sikringsfonde for landbrug, gartneri og fiskeri (Report No. 2/89 on the financing funds, levies, and securing for agriculture, gardening, and fishing)*, Copenhagen 1990.
12. This subject is developed in Rolf Elm-Larsen, "The Relationship between Value for Money Audit and Transaction Cost and Agency Theories", paper presented at the 5th Conference of Comparative International Governmental Accounting Research, Paris, May 1995.

THE ROLE OF INTERNAL AUDITING IN MANAGEMENT CONTROL SYSTEMS IN GOVERNMENT: A UNITED STATES PERSPECTIVE

by
Harry S. Havens⁸

Executive Summary

The U.S. government¹ has traditionally taken a casual, fragmented, and unsystematic approach to management controls. This is attributable, at least in part, to the separation of powers in the structure of the U.S. government. In a few areas, controls are established by law. In most cases, however, the development of management control systems has been left to the discretion of agencies² in the executive branch. Historically, the central agencies³ have provided little leadership in this area, and the operating agencies, left to their own devices, have given it low priority.

Recent initiatives suggest that this fragmented approach may be changing. In 1982, Congress required that agencies begin conducting annual assessments of their management controls. This was reinforced by a further requirement that, beginning in 1996, the 24 largest agencies must issue audited financial statements, with the audit report to include an assessment of controls. Most recently, in 1995, the executive branch issued new guidance, consistent with the INTOSAI *Guidelines for Internal Control Standards*, which re-emphasized the importance of effective management controls.

These initiatives reflect a favourable change in direction and attitude, but it would be premature, at this time, to predict their long-term effects. Moreover, even the best management controls have limitations. They may be subverted or evaded by the managers they are intended to serve, as U.S. experience shows, and they must be scrutinised regularly to ensure that they remain effective in a changing operating environment.

The internal audit function should be an important element of the management control structure. U.S. government internal auditors have traditionally served the managers of an agency, in contrast to external auditors, such as the General Accounting Office (GAO), who serve the organisation's outside overseers, primarily the Congress.

Government auditing is made more difficult in the United States by programmes in which government reimburses others for the costs incurred in providing goods and services to the government or in providing benefits on behalf of government. This requires auditors to examine the management controls

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of the government's suppliers and agents, as well as the control structure within the agency. Recent audits reveal continuing serious problems in the control environment of those with whom the government does business.

In 1978, Congress changed the structure for internal audit. It created the Inspectors General (IGs) in most agencies. IGs are in the somewhat awkward position of being part of the agency, but having considerable independence and important external reporting duties. They are expected to audit agency operations and programmes in the manner of traditional internal auditors, but they report their results to Congress, as well as to agency managers. IGs also are required to audit the agency's financial statements in the manner of an external auditor.

There have been problems with this approach. The external duties appear to have dominated, at the expense of the traditional mission of the internal auditor. In particular, exposing individual cases of wrongdoing -- a matter of special interest to Congress -- has received greater emphasis than strengthening the management controls that could prevent abuse.

In sum, the U.S. approach to management controls has had numerous weaknesses. Current efforts to strengthen controls appear promising, but their success will require commitment over an extended period, and sustained commitment is difficult to ensure in the U.S. system of government.

1. Framework for management control in U.S.

It is difficult to generalise about practices in this area because there is no unifying theme. There is in fact a great deal of diversity in the establishment and management of the various types of management control systems and in the rigour of their implementation.

Authority for management controls

The authority to create or to require management controls -- or any other administrative practice -- derives from the Constitution of the United States, which vests legislative power in the Congress. No official may take any action except in accordance with the Constitution or laws enacted by Congress through constitutional procedures. These legislative powers are limited, however, by the President's power to veto proposed laws and by the power of the judiciary to determine whether or not laws that have been enacted conform to constitutional requirements. Thus, within these limits, the Congress, acting in accordance with the Constitution, is the basic source of authority for all management controls. However, it has often delegated this authority to officials of the executive branch by the enactment of laws granting them explicit or implicit power.

Development and promulgation of management controls

The fragmented U.S. approach to management controls is typified by the diversity of ways in which such controls are established. The Constitution itself contains some basic management controls, although few Americans would think of those provisions in such terms. For example, it provides that taxes may not be levied and public funds may not be spent except in accordance with laws enacted by Congress. It also states that there must be an annual accounting for government receipts and expenditures.

Other management controls have been established in specific laws enacted by Congress. These include the creation of the General Accounting Office (GAO) as the supreme audit institution and of the Office of Personnel Management (OPM) to regulate government personnel practices. Other laws have been enacted to require financial audits and annual assessments of management controls and, for example, to regulate government contracting procedures.

The President, as the head of the executive branch, and the central management agencies, acting on his behalf, have certain management control responsibilities. These include such matters as the appointment of senior officials and the regulation of government accounting practices.

Finally, each agency, if not otherwise constrained, is responsible for various elements of the management control structure. Most agencies have considerable discretion in terms of deciding their organisational structure, setting the criteria for subordinate officials and defining their responsibilities, selecting the incumbents of those positions, and establishing their internal operating procedures.

Role of the central agencies

In theory, the U.S. central agencies should play an even more important role in developing effective management controls than such agencies do in most other countries. The leadership cadres in the operating agencies (typically reaching three or four levels down in the organisation) usually are politically

appointed officials who have brief tenures in office (averaging little more than two years). These officials are typically chosen primarily on the basis of their political affinities; they often have little or no prior management experience, especially in government organisations.

In this environment, the creation of effective management controls requires strong leadership from outside the agency. Specifically, it requires continuing firm commitment on the part of the central agencies to whom successive Presidents have delegated general management responsibilities for the executive branch. Until recently, that commitment was largely lacking, as was the equally necessary congressional support for effective management controls. For example, standards for reporting financial transactions have existed for many years, but they were designed to support the annual budget process and Treasury's required annual report on government finances, not to ensure the availability of the reliable cost data needed for agency management. Only in the last decade have efforts begun on such basic elements of accounting procedures as the design of a standard general ledger for government agencies.

Similarly, government personnel practices have been closely regulated for more than a century. The original intent was to insulate civil servants from improper political influence and to ensure that personnel decisions were based on the objectively measured abilities of competing candidates. Most managers, however, have long believed that the system emphasized form rather than substance and thus made it difficult to hold subordinates accountable for their performance. Efforts are now being made to rectify this problem.

The Office of Management and Budget (OMB) has repeatedly called attention over the years to the need for strengthened management controls. However, its statements have not been accompanied by the sustained commitment or the resources needed to achieve meaningful results. One hopes that the new emphasis placed on this issue by OMB will have more enduring results.

To understand the weak performance of the U.S. central agencies in developing effective management controls, one must recognise that their leadership cadres are also primarily selected on the basis of their political allegiances, not their management skills and experience, and that they, too, change very rapidly. In addition, Congress zealously protects its authority over the operating agencies and often acts to insulate them from what it (and the agencies) consider to be "interference" by the central agencies. In this context, the central agencies (especially OMB) are often viewed as agents of the President's policy objectives, not as politically neutral proponents of sound management practices. In reality, of course, the central agencies have both political and management responsibilities, and it is often difficult to maintain a balance between these two roles.

Comparison with the INTOSAI Guidelines

The U.S. government defines management controls as the organisation, policies, and procedures used by agencies to ensure that:

- programmes achieve their intended results;
- the use of resources is consistent with the agency's mission;
- programmes and resources are protected from waste, fraud, and mismanagement;
- laws and regulations are followed;

- reliable and timely information is obtained, maintained, reported, and used for decision making.⁴

This definition, and the guidance accompanying it, are fully consistent with the INTOSAI Guidelines. The U.S. government (and especially the audit community within the U.S. government) strongly supported the development of the INTOSAI Guidelines and has endorsed the published results. Unfortunately, even the most sincere belief in the importance of management controls does not immediately produce effective control systems. The difference between rhetoric and reality, moreover, is probably not unique to the United States.

Monitoring and evaluating management control systems

Until recently, the assessment of an agency's management controls was largely the agency's responsibility, supplemented by occasional GAO audits. In 1982, Congress enacted the Federal Managers Financial Integrity Act (FMFIA),⁵ which requires the head of each agency to conduct an annual assessment of the management controls within that agency, to report the results of the assessment to the President and the Congress, and to provide a plan of action to correct any material weaknesses that are discovered. This legislation was reinforced by the Chief Financial Officers Act (CFOA),⁶ which requires an annual financial audit of the 24 largest agencies, with the audit report to include an assessment of management controls.

Resources, skills, and training for management control systems

The skill and dedication of those responsible for the various aspects of the management control structure largely determine their effectiveness. The inexperience and short tenure typical of an agency's leadership means that it usually has little inclination or opportunity to contribute significantly to the agency's management systems. Recognising this, Congress enacted laws creating new positions with potentially great significance for management controls in most agencies -- the Inspectors General (IGs) and the Chief Financial Officers (CFOs) -- and specifying the qualifications required of candidates for these positions. The effect appears to have been salutary. However, the standards are not very rigorous, and political considerations still play a role in the selection of these officials. Moreover, government salaries are not competitive with the private sector at this level of responsibility, and this sometimes makes it difficult to attract individuals of the desired quality.

The technical skills required of those working on management control systems can generally be taught, but the government's investment in such training has been irregular. GAO, for example, has made a major investment in professional training for its auditors and has provided considerable assistance in training other government auditors. Other relevant training is available through a variety of governmental and university-based programmes. The decision to use these training programmes is left to the agencies, who must cover the costs from their own budgets. As a general rule, the agencies have given relatively low priority to such training. In most areas, therefore, the necessary skills must be acquired on the job.

The level of resources committed to the improvement of management controls is, for the most part, left to the judgement of the agency leadership. In only a few cases, such as the financing of the operations of the IG units, are funds earmarked for management control activities.

2. Internal audit in the U.S. government

The common view in the United States is that the internal audit function is both a management control and a means by which management can ascertain whether other management controls are operating effectively.

Internal versus external audit

The role of the internal audit organisation is very different from that of the external auditor, although the two should co-operate wherever possible. The external auditor's primary function is to serve those outside an organisation with a legitimate interest in its affairs. In the private sector, for example, the external auditor's first responsibility is to provide reasonable assurance that published reports about the financial performance and condition of a company are reliable.

In government, the external auditor's responsibilities are typically much broader. In the United States, for example, GAO is responsible not only for assessing the reliability of financial reports by agencies, but also for assessing, on behalf of the Congress, the economy, efficiency, and effectiveness of the operations of those agencies and their compliance with applicable laws and regulations. Thus, GAO's role is to examine an agency's performance with respect to objectives that are of interest to the Congress. These may be very different from the objectives that are of interest to the management of the agency.

The internal auditor, on the other hand, is typically viewed as being primarily responsible to the management of the organisation. The Institute of Internal Auditors has defined internal auditing as:

... an independent appraisal activity established within an organisation as a service to the organisation. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.⁷

Origins of internal auditing

The internal auditing function initially emerged in the private sector, when the managers of large companies realised that an annual audit by external auditors did not sufficiently assure them of the accuracy of the routine financial data they used to make operating decisions, nor could it serve to prevent fraud or theft on the part of employees of the company. These managers realised that further auditing resources should be devoted to meeting the needs of the company's top managers. Thus was born the concept of internal audit organisations, independent from the operating and financial components of the company, which reported to the company's top executives and its board of directors.

In the early stages, the internal auditors typically concentrated almost exclusively on testing financial controls and ensuring the accuracy of internal financial reports. In time, however, internal auditors gained responsibilities covering the entire spectrum of management controls. Managers make decisions on the basis of many types of data, both financial and non-financial. Important operating reports may provide information about physical inventories (such as parts), operating schedules and deviations from them, product quality, etc. It is vital for these reports to be timely and reliable. Assessing the reliability of these reports, and of the information systems producing them, became a duty of the internal auditors. In time, their duties were extended to assessing compliance with the organisation's policies and to evaluating the effectiveness of the company's policies and procedures.

Government internal auditing

The evolution of the internal audit function in government followed a similar pattern. Initially, the internal auditors concentrated almost exclusively on testing the accounting systems and financial controls and ensuring the reliability of financial reports. Gradually, their duties expanded to encompass other issues of concern to the head of the agency and its senior managers, including the reliability of internal operating reports and operating unit compliance with management policies. The complex structure and diverse functions of the U.S. government, however, have led to internal auditing practices that are different in many ways from those in the private sector.

3. Legal framework for internal auditing

Internal audit organisations have existed in most agencies for many years. Most were initially created under the agency head's general authority to establish the agency's organisational structure. Frequently, the impetus to create such units was either a major internal management problem, such as the discovery of embezzlement, fraud, or corruption, or pressure from oversight agencies such as GAO and OMB. Until the 1970s, the internal audit unit in most agencies was subordinate to the chief administrative officer, who was also responsible for the agency's budgeting and financial reporting functions. The head of the internal audit unit was typically a career civil servant, often recruited from GAO, who usually had many years of auditing experience.

Creation of the Inspectors General

In 1978, Congress passed the Inspector General Act, which changed the organisation of the internal audit function.⁸ This law created the position of Inspector General in almost all agencies. In 30 agencies, the IGs are appointed by the President and must be confirmed by the Senate. They can be removed from office only by the President, who is required to communicate his reasons for doing so to Congress. In another 30 agencies, mostly smaller ones, the IG is appointed by the head of the agency, who also has the power of removal but must also explain that action in writing to Congress.

The law requires that the IGs be selected without regard to political affiliation and solely on the basis of integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations. In the larger agencies, they have a rank equivalent to an Assistant Secretary. In all cases, the IG is required to have direct access to the head of the agency. However, the head of the agency has only "general" supervisory powers over the IG and is prohibited from preventing the IG from conducting any audits and investigations that the IG deems necessary. These arrangements were intended to ensure that the IGs would be sufficiently independent from the operating components of the agency to carry out their duties effectively. This independence is further strengthened by the requirement that the IG's budget be kept separate from the rest of the agency.

IG responsibilities

The IGs have two major responsibilities. One is the internal audit function, which is headed by an Assistant IG (AIG) for Audits. The other is the investigation of allegations of misconduct or other violations of laws and regulations, under an AIG for Investigations. Such units had existed previously in most agencies but were generally separate from the internal auditors.

The IG Act also changed the reporting arrangements. Before it was passed, internal auditors generally reported the results of their work only within the agency. Usually, the reports were transmitted to the chief administrative officer, who would relay any important findings to the agency head. However, the auditors always had authority to report directly to the agency head where necessary, if, for example, the report contained adverse findings concerning the chief administrative officer. Usually, the internal auditors also shared the results of their work informally with GAO in order to minimise duplication of effort.

Under the IG Act, the IG is required to submit all reports directly to the head of the agency and is also required to keep Congress fully and currently informed of their work. The IG is required to submit twice yearly, to the head of the agency, a report on the audit and inspection work. The agency head must forward this report, along with any comments he wishes to add, to the Congress within 30 days. If the IG discovers "particularly serious or flagrant problems", they are to be reported immediately to the agency head, who must forward the report to the Congress within seven days. The head of the agency is not permitted to change the content of any IG report.

Ambiguous roles

This dual reporting arrangement was intended to protect the independence of the IG. However, it also was intended to ensure that knowledge of major problems discovered by the IG would not be confined to the agency, but would be widely disclosed so that they could be resolved quickly. Whatever the reasoning, the requirement to report to Congress clearly changed the role of the internal audit unit (and the investigations unit as well) from exclusively serving the needs of the top agency managers to serving a broader audience. This has considerably changed the views of the function of the internal auditors held by both agency managers and interested external parties, especially those in Congress. The requirement that the IGs report to Congress raises questions about the extent to which the internal auditors can now properly be viewed as a "service to the organisation", as described by the professional organisation of internal auditors.

The growing importance of the congressional audience for the internal audit and other work of the IGs is demonstrated by the frequency with which the IGs now appear before committees of Congress to testify about issues affecting their agencies. For example, in the first half of 1995, the IG for the Department of Housing and Urban Development (HUD), a relatively small agency but one with many long-standing management problems, appeared four times before various congressional committees to present her views on some of these problems.

New emphasis on management controls

In addition to the responsibilities set forth in the IG Act, subsequent legislation has increased the duties of the IG. The FMFIA requires the head of each agency to assess the adequacy and effectiveness of its management controls every year and to report the results of that assessment to Congress. If this assessment discloses any material weaknesses, the agency's report must include the actions it is taking or plans to take to correct the problem. The report must also state specifically whether or not the agency's financial management systems conform with government-wide requirements established by OMB.

The assessment required under the FMFIA is a responsibility of the managers of the agency, not the auditors. Each manager should prepare an assessment of the management controls for each of the functions for which he is responsible, with the internal auditors providing advice and reviewing the results for the benefit of the head of the agency. This is intended to ensure that the managers understand the

control systems for which they are responsible and the importance of maintaining their effectiveness. While the internal auditors are not responsible for this assessment, they play a vital role by pointing out problems that may have gone unnoticed and by suggesting ways of strengthening controls that are inadequate.

Annual financial audits

The U.S. government does not have a tradition of issuing audited financial statements like those required of most large private sector companies. Government-owned corporations are the main exception. These are fewer in number than in most other countries, but they have been required to issue audited financial statements since the late 1940s. At one time, most audits of government corporations were conducted by GAO; today, most are performed by private accounting firms and occasionally tested for quality by GAO.

In a recent innovation, the CFOA has required the 24 largest government departments and agencies to issue audited financial statements beginning at the end of 1996; it has also required the Treasury Department to issue consolidated statements for these agencies in 1997. GAO must audit the consolidated statements and may choose to perform any of the required agency audits. The IGs are required to perform the audit of their agencies if GAO chooses not to do so.

Arrangements for the agency audits are still evolving. GAO, lacking the staff resources to conduct all the audits, plans to concentrate on the consolidated statements and on key components of some of the larger agencies, such as the Treasury and the Defense Departments.⁹ In some of the other agencies, the IGs expect to perform the entire audit. In others, the IGs will contract for the audit with private accounting firms or will share the auditing work with such firms.

The extensive participation of IGs in the annual financial audit further illustrates their ambiguous role. The audit of an organisation's public financial statements is usually viewed as the responsibility of auditors who are independent of the organisation being audited. That is the role of the external auditor, not the internal auditor. GAO has determined that the IGs, who are appointed by the President and required to report to the Congress, are sufficiently independent to carry out this function. However, it may prove difficult for the IGs to balance that quasi-external audit responsibility with the traditional internal audit role of providing "service to the organisation".

4. Policy guidance for internal audit

Implications of the separation of powers

The promulgation of standards for a variety of matters concerning financial management is made more complex by the separation of powers in the U.S. government. GAO, the government's external auditor, is located in the legislative branch of government and is authorised to issue standards for accounting and auditing in the federal government. However, it has no power to enforce those standards, other than to report instances of non-compliance. Senior officials in the executive branch have often taken the view that standards promulgated by GAO should be considered advisory, not compulsory. GAO's standards for government auditing¹⁰ are widely accepted, not only in the federal government but also by auditors in state governments in the United States and by government auditing organisations in other countries.

The IGs, of course, are located in the executive branch, which does not acknowledge GAO's authority to prescribe standards. The IG Act specifically requires the IGs to conform to the GAO auditing standards, and the executive branch has not challenged that requirement. Indeed, in some circumstances, as in the auditing of grants made to state and local governments, executive branch instructions reinforce the requirement that auditors comply with the GAO standards. However, on the basis of a previous court decision in an unrelated matter,¹¹ it appears likely that if this requirement of the IG Act were challenged, the courts would rule that it is an unconstitutional infringement of the doctrine of the separation of powers.

Other ways of developing standards

In other areas, the approach to the development of standards has been somewhat different. The executive branch has explicitly rejected GAO's authority to promulgate accounting standards for the government. At one point, OMB stated its intention to develop its own set of accounting standards, without regard to those promulgated by GAO, and to require agencies to comply only with the OMB standards. In an effort to reach a mutually acceptable compromise, GAO and OMB agreed to create a separate body, the Federal Accounting Standards Advisory Board (FASAB), with representation from OMB, GAO, Treasury, several large agencies, and non-government experts, to propose a new set of accounting standards for the government. These proposed standards would then, if approved, be promulgated and enforced by OMB. FASAB expects to complete its work by the end of 1995 or early in 1996.

The approach taken with respect to standards for management controls is still another variation on the pattern. As in the other cases, GAO has issued standards,¹² but it is doubtful whether they can be enforced beyond criticising an agency's failure to comply. Recently, OMB issued its own instructions to government agencies on management controls (see note 4). While these standards were issued under OMB's authority, OMB stated explicitly that they were largely drawn from the GAO standards. All things considered, the consensus-building model being tried in the accounting standards area (if it proves successful) appears to be a better way to develop standards, despite the time required for such decision making.

5. Scope of internal audit responsibilities

Complex financial relationships

The duties of a U.S. government internal auditor are greatly affected by the diverse and complex financial relationships that obtain between the government and other parties. In principle, the internal audit unit is responsible for examining all aspects of an agency's operations and the resources entrusted to it.

Relatively few of the goods and services for which the government pays are actually produced or delivered by government employees. For example, the government finances a considerable share of the nation's health care services but only a small part of these services is delivered by federal employees. Most people receive their services from independent health care providers. The federal share of the fees charged by these providers is paid through intermediaries. In some cases these are private insurance companies. In others, it is a state government, who may then use an insurance company as its own intermediary in dealing with the health care providers.

Similarly, virtually all of the facilities and equipment used by government personnel are actually produced under contract by companies in the private sector. Government office buildings, for example, are built (and often routinely maintained) by private contractors. More importantly, the weapons employed by

the military services and the space exploration equipment used by the National Aeronautics and Space Administration (NASA) are all produced by private companies under contracts with the government.

Auditing management controls in health care

These complex financial relationships broaden enormously the potential responsibilities of an agency's internal auditor because, in principle, the auditor should examine the entire stream of federal funds to the eventual recipient. The Medicare programme, which finances health benefits for the elderly, for example, is managed by the Health Care Financing Administration (HCFA) in the Department of Health and Human Services (HHS). An HHS auditor who seeks to assess the management controls in that programme is only beginning the process when he looks at controls within HCFA. He must also examine the management controls of the insurance companies that act as intermediaries, of which there is one in each of the 50 states.

Audit objectives

In the intermediaries, the auditor needs to assess the reliability of the safeguards against the charging of improper fees by the independent health care providers, such as fraudulent fees for services not provided or provided to a patient needlessly, fees that exceed established limits, or fees for services provided to one patient and charged to another. If those safeguards are judged insufficient, a complete audit would, in theory, require the auditor to examine the management controls of the actual health care providers, of which there are thousands.

Audit strategy

Resource limitations preclude audits along these lines. HHS has only a few hundred internal auditors, who are responsible for overseeing hundreds of billions of dollars of expenses. Medicare is only one of many programmes they oversee, and assessment of management controls is only one of many assignments given to the staff that covers health care financing. An audit of the Medicare programme must take a much more focused approach.

Based on past experience, the design of the programme, and the financial incentives created by that design, the auditor is likely to begin with the assumption that if weaknesses exist, they are most likely to be found in the controls of intermediaries and health care providers. Therefore, he may decide to look at only a few of the controls within HCFA, such as those in the billing and payments systems. However, he will discuss with the HCFA managers their informal assessment of the controls in the intermediaries and in some of the major health care providers, such as the largest hospitals. The auditor will then select a few of the intermediaries, probably no more than five or so out of the 80 or more contractors who are responsible for processing, payment, and review of Medicare claims, for a relatively detailed examination of controls.

Pursuing evidence

If the auditor finds weaknesses in the management controls of the intermediaries, this only demonstrates that federal funds might have been spent improperly without being detected. There is no proof that such abuse has actually occurred. To convince his audience that the problem is real and warrants

corrective action, the auditor needs evidence of actual fraud or waste of money. To gather this evidence, he must examine the activity of the health care providers (doctors, hospitals, pharmacies, etc.) and the fees for which they obtained reimbursement from the intermediary.

The auditor will look at the records of a few of the providers, searching for a variety of ways in which (on the basis of previous experience) he believes it possible that federal money was used inappropriately. Many Medicare reimbursements are based on the doctor's diagnosis of the illness. Thus, the auditor might look for cases where a more severe diagnosis (entailing higher reimbursement) was recorded than was justified by the available information and would examine the procedures used by a hospital to ensure the accuracy of the diagnosis in borderline cases. The auditor will also look for evidence of fraud, which usually takes the form of charging fees for services not rendered or for serving patients who were never seen.

Proposing solutions

Once the auditor has gathered the evidence of weak controls and, if possible, evidence of actual losses resulting from those weak controls, he is also expected to suggest ways to correct the problem. Sometimes this can be a relatively simple procedural change. For example, the intermediaries who handle Medicare payments use sophisticated computers to record the data on automated systems. They can thus perform a variety of tests, which can often reveal indications of possibly inappropriate payments. Using statistical tests, they can identify doctors who consistently depart from the norm in terms of the number of patients treated and the severity of the diagnosis. Such anomalies suggest the possibility of abuse. This approach allows the limited resources available for detailed examination of providers to be applied to the cases where abuse or fraud are most likely to be found.

Management controls and programme design

Sometimes, however, the problem is too fundamental to be readily solved by procedural changes. The structure of the U.S. health care system, in which a myriad of independent health care providers receive their income primarily in the form of fees for services delivered, paid not by the individual patient but by many third parties (chiefly insurance companies), makes the system vulnerable to abuse. The same is true of the Medicare programme. Statistical tests can help reveal the most flagrant abuses, but they will not reliably reveal the doctor who only occasionally supplements his income by charging for "phantom" patients or elevating a diagnosis.

Installing management controls adequate to detect this type of abuse reliably is likely to cost more than the abuse the controls would be intended to prevent. In addition, the controls might be so intrusive as to impede medical staff who are carrying out their legitimate duties.

Limitations of controls

This is not to say that management controls are ineffective in a programme such as Medicare, but only that they have limitations. At some point, it is necessary to rely on the basic honesty of most of the people who participate in the system, on the threat of severe penalties for those who are found abusing it, and on a set of management controls (including such techniques as statistical tests and unannounced random examinations of the records of health care providers) that provides reasonable assurance that flagrant violations will be detected. In those circumstances, abuse would no doubt continue, but it would be reduced to "acceptable" levels.

Current situation

Unfortunately, the Medicare programme today is far from achieving such an acceptable level. The following remarks appear in a recent GAO report:

In 1992, we reported that Medicare was one of several government programs considered highly vulnerable to waste, fraud, abuse, and mismanagement. Problems we noted included inadequate funding of Medicare claims processing contractors' activities to control fraud and abuse, weaknesses in the HCFA management of Medicare contractors, flawed payment policies, and weak billing controls. Since then, HCFA has made various regulatory and administrative changes aimed at correcting these problems. However, these worthwhile improvements still are not sufficient to protect Medicare against continued losses.¹³

The report goes on to note that, "today Medicare pays more claims with less scrutiny than at any other time in the last five years" and that "inadequate funding has stunted the development of new controls to protect Medicare benefit dollars". It seems evident that Medicare, a programme for which the federal government spent \$162 billion in 1994, is a long way from having adequate management controls.

Medicare represents one of the most difficult situations facing an internal auditor. There are many participants, they have complex financial relationships, and their financial incentives are not such as to induce them voluntarily to institute effective management controls. Unfortunately, similar situations are found in most of the social programmes operated by the federal government.

Auditing management controls in defence contracts

Cost-based contracts

Different, but comparably severe problems face the internal auditor working on programmes involving the procurement of goods for government use. This is particularly the case in the Department of Defense (DOD). As noted earlier, virtually all weapons are bought from private companies, who supply them under contracts. In most cases, these contracts are negotiated with little, if any, competition. Typically, the contract provides that payment to the contractor will be set in one of two ways. In some cases, the price is negotiated on the basis of the contractor's estimate of the costs of production. In other cases, the contract provides that the company will be paid primarily on the basis of the costs it actually incurs in producing the item. (Efforts to shift to the practice of buying complex weapons systems on the basis of competitive bidding and fixed prices have largely failed.)

Dependence on contractor data

These contractual arrangements leave the government dependent on information from the company when judging how much to pay it, so that it is essential that the company's costs (or estimated costs) are accurately reported. As a general matter, however, it is in the company's interest to inflate the reports of estimated and actual costs. Thus, as in the Medicare programme, an auditor's scepticism concerning data supplied by the company is justified.

DOD has wrestled with this problem for many years. It has created a separate auditing organisation, the Defense Contract Audit Agency (DCAA), with a staff of about 4 000 whose specific mission is to audit defence contracts totalling well over \$100 billion per year.¹⁴

Auditing cost estimates

With respect to contracts for which the price is negotiated on the basis of estimated costs, DCAA examines the reliability of the company's cost estimates. When the contract is being negotiated, the company is unlikely, for example, to have established a definite price for components purchased from another firm (a subcontractor). That price will be set in separate negotiations between the two companies after the prime contract has been approved. The prospective prime contractor may base his estimate on previous purchases of similar components or on list prices published by the anticipated subcontractor. However, the prime contractor may be able to negotiate a substantial discount from the subcontractor's list price, thereby potentially adding considerably to the profits anticipated in the initial negotiations.

When DCAA auditors examine these contracts, they must judge whether or not the estimated costs submitted by the prime contractor as a basis for contract negotiations were "reasonable". If the contractor could reasonably have anticipated obtaining discounts from the subcontractor and did not disclose this during the contract negotiations, the price set in the contract would be "defective" and the government would be entitled to a lower price.

Examining individual contracts for defective prices is necessary, if only as a deterrent to abuse, but it is a very labour-intensive way to attack the problem. A better approach is to ensure that contractors use a reasonable method of estimating costs. Most major government contractors have cost-estimating systems. DCAA resources can appropriately be used to examine whether these systems have reasonable estimating techniques and controls to prevent the problem of defective pricing from arising. These would include, for example, a factor reflecting the likelihood (based on previous experience) that subcontractors will agree to substantial discounts from list prices.

DCAA has invested considerable resources in assessing such cost-estimating systems and seeking to improve them. The results of these efforts have been encouraging but uneven. In 1995, GAO reported:

We recently reviewed the 30 DOD contractors that DCAA assessed as having high-risk cost estimating systems. According to DCAA, these contractors had a total of 117 significant deficiencies in their cost estimating systems. We found that contractors' performance in correcting these deficiencies has been mixed. Although 19 of the 30 contractors had corrected ... all their significant deficiencies, the remaining 11 contractors had significant uncorrected deficiencies that had been outstanding an average of 3.8 years. The failure to correct these deficiencies in a timely manner creates a variety of problems for the Defense Department, including increased costs and delays in contract awards.¹⁵

Auditing actual costs

Contracts in which the government reimburses the contractor for costs actually incurred present a different set of management control and audit issues. Again, the government is dependent on the contractor and his cost accounting system for the data on which to base payments under the contract.

The amounts reflected in contractor cost reports should include only costs authorised under the contract. Two types of errors are often found. One is the attribution of costs to a DOD project that were actually incurred for another purpose. For example, salaries and wages of workers may be charged to the project for periods of time when they were not working on the project. To guard against these errors, DCAA auditors typically examine the company's cost accounting system and, especially, the management controls that are intended to ensure that all costs are allocated to the proper project.

Another frequent error in the cost reports is the inclusion of amounts that are not authorised for reimbursement under the contract. Most cost-based contracts permit the contractor to charge the government not only for the direct costs of the project but also for a portion of the company's overhead costs. This has proven to be a problem, because not all overhead costs are authorised for reimbursement.

Federal laws and regulations specifically prohibit certain types of spending, such as lobbying and entertainment, from inclusion in the "pool" of overhead costs that may be allocated to government projects. Other overhead costs may be excluded if they are not necessary for conducting business. Federal regulations require that government contractors establish systems to identify and exclude unallowable costs from their overhead cost submissions. However, contractors have a financial incentive not to pursue this matter aggressively. The results can be seen in the following remarks from a recent GAO report:

Unfortunately, these systems do not work as well as they should. Over the years, we and DCAA have questioned the allowability of billions of dollars of costs included in contractor overhead submissions.

Our past work has shown that the inclusion of unallowable costs in contractor overhead submissions resulted in large measure from weaknesses in contractor procedures for screening for unallowable costs.¹⁶

These examples show that the responsibilities of a government internal auditor do not necessarily end at the boundaries of the agency where he or she is working. If money flows from that agency to another party, such as a contractor or another level of government, and the amounts paid depend on the reported performance of the other party, the internal auditor may be required to examine the other party as well. Protection against abuse, waste, and fraud may depend far more on the management controls maintained by the other party than on those operating within the agency itself.

6. Limitations of management controls and internal auditing

Inherent limitations

Management controls are essential in an agency, both as a safeguard against waste, abuse, and fraud, and as a means of ensuring that the policies articulated by management are properly implemented by the organisation. Internal audit is essential both for assessing the effectiveness of the controls and for detecting instances where controls are bypassed, either intentionally or accidentally. Continuing vigilance is necessary, however, because changing circumstances and operating procedures can render even the best control system ineffective.

There are other limitations on the effectiveness of management controls. As the Medicare example showed, it is impossible, for a complex programme involving millions of transactions each year, to develop cost-effective management controls and auditing procedures that reliably prevent or detect occasional abuse on a relatively small scale. Moreover, even well-designed management controls serve their purpose only if personnel comply with the controls and management responds to reported anomalies.

In a recent case involving the Singapore branch of Barings bank, it is reported that supervisors took no corrective action in the face of reports that one of the bank's traders was operating far beyond the limits set by bank policy. In a relatively short period of time, the losses incurred by that trader rendered the entire bank insolvent. If management controls, and the information they provide, are ignored, they are worse than useless because they can create a false sense of security. But there is another, even more important, limitation on the capacity of management controls to prevent abuse.

Abuse by top managers

Management controls are intended to give reasonable assurance to the top managers of the organisation that subordinate elements of the organisation are following management policies and safeguarding the financial interests of the organisation. They allow top managers to control the organisation; they do not control the top managers themselves.

Unfortunately, controls can easily be defeated by managers. The private sector has seen many instances in which top managers, having bypassed the firm's management control systems, embezzled or misappropriated large sums of the company's assets. The collapse of the U.S. savings and loan industry revealed many such control failures.¹⁷

7. The HUD scandal

Regrettably, the inability of management controls to prevent malfeasance by top managers has been demonstrated in government as well. The "HUD scandal" is basically the story of political officials who bypassed the agency's normal procedures and management control systems in order to divert scarce agency resources to the benefit of politically influential friends.

Background

The Department of Housing and Urban Development (HUD) is a relatively small agency, established in 1965 to operate a variety of programmes designed to encourage the production of housing, especially for families of modest means, and to provide financial assistance to cities. It has been characterised by weak management and frequent episodes of corruption. In the past, corruption typically involved employees in local HUD offices (or private contractors acting as agents of HUD) who acted in collusion with those doing business with HUD to defraud the government. In the 1980s, however, in a sharp departure from this pattern, corruption reached the highest levels of HUD's management.

Simple embezzlement

The HUD scandal involved several different types of malfeasance, which were exposed in the late 1980s and came to be viewed as evidence of HUD's incompetent and corrupt management. One case, for example, not connected to the political corruption, involved a real estate agent who was authorised to sell property owned by HUD. Instead of remitting the proceeds to HUD, she retained them for her personal use. The most rudimentary management controls should have revealed this immediately. Instead, the thefts continued for some time and eventually involved several million dollars.

Political manipulation

By itself, this case would probably have been seen as just one more instance of dishonesty on the part of those with whom it did business. However, it was coupled with the exposure, at about the same time, of politically motivated corruption by HUD's top executives. In the 1980s, HUD's leadership was dominated by a group of executives who were chosen for their political allegiance, not for their

management skills or their knowledge of HUD's programmes. Some of these individuals undoubtedly became dedicated, effective managers. Others did not and, instead, devoted themselves to serving the financial interests of political allies outside government.

Political manipulation of HUD's programmes was facilitated by two factors. First, the Department's leadership and, indeed, that of the executive branch as a whole, was hostile to the Department's programmes. Several proposals to terminate HUD programmes had been rejected by Congress. Thus, the executive branch had little interest in effective management of the programmes.

A second factor was the design of some HUD programmes. In several of them, the Secretary of HUD had virtually complete discretion in the matter of project selection. It became common knowledge in certain circles that the Secretary, working with or under the influence of his Executive Assistant, was prepared to allocate programme funds as political favours. Investors wishing to have a project approved by HUD learned that the way to succeed was to hire as a "consultant" an individual whose political connections gave him access to the Secretary or his Executive Assistant. At the consultant's request, the Secretary or his Executive Assistant either approved the project or instructed other HUD officials to do so.¹⁸

Role of the IG

It is unrealistic to think that management controls might be an effective defence against corrupt top management, especially if the programme is inherently vulnerable because of its flawed design. Nevertheless, it is instructive to look at the performance of the HUD IG during this period, especially in view of the supposed independence of the IG under the IG Act.

The IG was responsible for the initial exposure of the corruption in the spring of 1989.¹⁹ However, his report emphasized the political manipulation of project approvals by a lower-level official (an Assistant Secretary), not the corruption at the top. Moreover, the report was issued well after the responsible Secretary had left office, and it is now evident that the problems began at least as early as 1984.

It is not clear why the IG failed to examine this issue earlier. Political manipulation of project approvals apparently was common knowledge within HUD during this period. There is no evidence that the IG was involved, and his semi-annual reports show that he was concerned about the weakness of HUD's controls and the vulnerability of its programmes. The reports are replete with references to these problems. In each case, however, expressions of concern are coupled with reassurances about HUD's efforts to correct the problems, efforts that never seemed to make much progress.

One possible explanation for the IG's ambivalence in reporting on management control problems (and perhaps for his failure to examine the problem of political manipulation of project approvals) is that he truly believed that HUD management was committed to strengthened procedures and controls and that any mistakes were aberrations, rather than part of a pattern of mismanagement. That explanation, however, is belied by the fact that the reassurances continued, year after year, in the face of manifest failure to make the promised improvements.

Divided loyalties and responsibilities

A more likely explanation lies in the divided loyalties created by the IG Act. Should the IG's loyalties lie primarily within the organisation, in the tradition of the internal auditor? If so, the IG should be aggressive within the agency, especially in urging the importance of management controls, but

circumspect in his public remarks. Should the IG's loyalties lie with the President, who appointed him and can dismiss him at a moment's notice? This, too, suggests circumspection in public, particularly since the then President showed no interest in management matters but a strong loyalty to his political friends. Or should the IG's loyalties lie with Congress, to which he must report and which decides his budget? This would suggest a more aggressive public posture, particularly on the individual cases of wrongdoing for which Congress has such an appetite.

It appears that the HUD IG attempted to weave his way among these loyalties, without offending anyone. He reported the individual cases of wrongdoing of interest to Congress, but he played down any criticism of HUD management, thus avoiding the sensitivities of political leaders in the executive branch. Apparently, the IG did seek to convince the Secretary of the need for stronger controls, but retreated in the face of the Secretary's reluctance to see the issue pressed. This is hardly an appropriate stance for an auditor, but it is also fair to point out that it would have taken an unusually strong person to have done otherwise, in view of the conflicting loyalties created by the IG Act.

8. Strengths and weaknesses of the IG system

More than 15 years have passed since the passage of the IG Act. It is reasonable to begin judging the wisdom of that legislation. Many observers have concluded that, while the IG Act was well-motivated and IGs have achieved some important results, there are some major flaws in the law and in the operations of the organisations which it created.²⁰

It can be said in its favour that the IG Act increased the independence of the investigators and internal auditors by giving them an external reporting venue. This brought them greatly increased public visibility which, coupled with independent budgets, allowed the IGs to compete successfully for staff resources. However, their independence is far from complete. The President retains the power to dismiss the IGs, as President Reagan did *en masse* in 1981. Thus, the IGs are faced with conflicting loyalties, which can make things very awkward.

Exposing fraud and abuse

By some measures, IG resources have been used effectively. IG offices (including both auditors and investigators) have found and exposed many cases of malfeasance on the part of employees or agents of the government. In most cases, even when there are indications of criminal wrongdoing, only administrative penalties are imposed. In part, this reflects the difficulty of developing the evidence necessary to obtain a conviction, but it also reflects the reluctance of prosecutors to pursue any but the most egregious cases because of limits on their own resources and on the capacity of courts and prisons.

Improving controls

On the other hand, progress on improving the management controls that might prevent wrongdoing has been very slow. The continuing problems in HUD, the Medicare programme, and defence purchases make this obvious. It is not yet clear whether or not the more recent initiatives (FMFIA and CFOA) will accelerate progress. The reasons for the IGs' relatively ineffective performance in this area may well lie in the incentives created by the dual reporting requirement.

Congressional interest

As the IGs found themselves increasingly serving an audience in Congress, they learned that U.S. legislators find it much more rewarding politically (in terms of their prospects for re-election) to expose individual cases of abuse in government programmes than to strengthen the management controls that might prevent abuse. Legislators encourage the IGs to come to them with cases of individual malfeasance but give little or no attention to reports of weak management controls.²¹ It seems clear that, for this reason or for another, the IGs have emphasized the search for individual cases of wrongdoing at the expense of working to strengthen management controls.

Prospects for change

Now that the IGs have become, at least in part, responsible to Congress, it is unlikely that the emphasis on individual cases will change in the short run. Nor is it likely that the IG structure itself will be altered dramatically in the immediate future. The IGs have established a reputation as guardians of rectitude that makes it difficult for others to suggest the need for change. Moreover, Congress continues to reap the political rewards of the present emphasis and would have little interest in changing IG priorities.

The most likely source of increased emphasis on management controls is pressure from the FMFIA and CFOA, combined with an emphasis on serious management reform by the leadership in the executive branch. Such a combination might lead to a reorientation of the priorities of the IGs or, failing that, to the creation of new units committed to improved management, including strengthened controls.

The Clinton administration has voiced a strong commitment to effective management. Whether it has the political strength to follow through on that commitment, given a Congress controlled by the other party, remains to be seen. In addition to possible political opposition, however, management reform, including stronger management controls, faces another obstacle. Controls cost money, at least in the short run, and money is hard to find in the present budget environment. Short-sighted though it may be, the strong temptation is to cut the funds for management improvement along with everything else. For the time being, the outlook for appropriate emphasis on management controls in the U.S. government is uncertain, at best.

9. Conclusion

Effective management controls are essential to any successful organisation. Internal audit is a vital component of an effective management control system, in part because of its ability to detect and deter wrongdoing, but, more importantly, because of its ability to assess the effectiveness of other elements of the control system.

As the U.S. experience shows, building an effective structure of management controls is difficult. The more complex the structure of government and its relationships with other parts of the economy, the more complicated and extensive are the necessary management controls, and the more difficult it becomes for the internal auditor to judge how best to apply limited audit resources. Moreover, well-intentioned legislation can have perverse effects. The IG Act, which was intended to strengthen the internal audit and investigation functions by making them accountable to the President and Congress, has instead created divided and potentially conflicting loyalties.

Finally, vital as they are, management control systems, including a strong internal audit organisation, can never provide absolute protection. To be effective, management controls must be enforced rigorously and consistently, even when urgent time pressures suggest otherwise. They must be constantly improved to ensure effectiveness in a changing operating environment. Finally, all management control systems -- including the internal audit unit -- can be defeated by the top managers they are intended to serve. In the final analysis, the management control system can only serve the managers; it cannot replace their competence and integrity.

NOTES

1. This paper addresses the issue of management controls in the federal government of the United States. As the 50 states have their own constitutions, laws and administrative practices, the issues may or may not be the same.
2. The term "agency" is used here to identify operating organisations in the executive branch of government. It should be understood to include cabinet departments ("ministries" in other governments) as well as independent agencies or other administrative organisations.
3. The term "central agencies" identifies the organisations in the executive branch that provide guidance to the operating agencies. There are a number of such central agencies, but those most relevant to the present discussion are the Office of Management and Budget (OMB), the Treasury Department, and the Office of Personnel Management (OPM).
4. U.S. Office of Management and Budget, "Management Accountability and Control," Circular No. A-123, Revised 21 June 1995.
5. The Federal Managers' Financial Integrity Act of 1982, Public Law 97-255, 31 U.S. Code 3512.
6. Chief Financial Officers Act, Public Law 101-576, 31 U.S. Code 901(b), 3515.
7. Cited in O. Ray Whittington, *et al.* (1992), *Principles of Auditing*, 10th edn., Richard D. Irwin, Inc., Boston.
8. Inspector General Act of 1978, Public Law 95-452, 92 Stat. 1101.
9. GAO, under the pressure of budget constraints throughout the U.S. government, is in the process of reducing its staff size of about 5 200 in the early 1990s to an expected level of about 3 500 at the end of 1997.
10. *Government Auditing Standards*, 1994 Revision, U.S. General Accounting Office, June 1994. This publication is often called the "Yellow Book."
11. *Bowsher v. Synar*, 106 Supreme Court 3181 (1986). The Supreme Court ruled that GAO was part of the legislative branch and that it was unconstitutional for Congress to seek to empower GAO to issue orders imposing formula-based spending reductions on the executive branch.
12. *Standards for Internal Controls in the Federal Government*, U.S. General Accounting Office, 1983. This publication is often called the "Green Book."
13. "Medicare Claims," GAO/HR-95-8, U.S. General Accounting Office, February 1995.

14. This implies an audit coverage of about one auditor for every \$25 million in contracts. Actual coverage is considerably less, because DCAA also performs contract audits on behalf of other agencies, such as NASA.
15. "Defense Contract Management," GAO/HR-95-3, U.S. General Accounting Office, February 1995.
16. *Ibid.*
17. The savings and loan industry consisted of a large number of financial institutions that were analogous in many ways to banks, except that they were intended primarily to finance the purchase of homes. Deposits were insured by the federal government, and the collapse of the industry in the 1980s involved several hundred billion dollars in costs to the government.
18. For a detailed examination of the HUD scandal, see "Abuse and Mismanagement at HUD", Report of the Committee on Government Operations of the U.S. House of Representatives, House Report 101-977, 1 November 1990, and "Final Report and Recommendations" of the HUD/MOD REHAB Investigation Subcommittee, Committee on Banking, Housing and Urban Affairs, United States Senate, November 1990.
19. "Thomas T. Demery, Section 8 Moderate Rehabilitation Program," Report of Investigations, Office of Inspector General, Department of Housing and Urban Development, No. HM 1-1054, 17 April 1989.
20. For a more extensive assessment of the IGs, see Paul C. Light (1993), *Monitoring Government: Inspectors General and the Search for Accountability*, The Brookings Institution, Washington, D.C.
21. There are obvious exceptions, such as the legislators who were responsible for enactment of FMFIA and CFOA.

THE ROLE OF THE EXTERNAL AUDITOR IN MANAGEMENT CONTROL SYSTEMS IN GOVERNMENT: A UNITED KINGDOM PERSPECTIVE

by
Dudley Lashmar⁹

Executive Summary

The National Audit Office (NAO), headed by the Comptroller and Auditor General, is the supreme audit institution of the United Kingdom and, as such, has external audit responsibility for central government public expenditure.

The Treasury, a government department, is responsible for the development and promulgation of management control systems within government.

The NAO is entirely independent of the Executive, as represented by the Treasury or the government as a whole. The Comptroller and Auditor General, who is appointed by Parliament, is responsible for appointing the staff at the NAO and reports to Parliament via the Public Accounts Committee, a Parliamentary committee with members drawn from all political parties.

The NAO's prime concern is to provide accountability to Parliament -- by certifying government department accounts and undertaking value-for-money investigations -- for the proper and efficient collection and spending of public funds and for the management of resources.

Detailed management control systems within government have not been laid down within legislation but have been promulgated by the Treasury. The Treasury's guide, *Government Accounting*, is the principal basis upon which government departments have developed management control systems designed to meet the needs of central guidance and their own operational needs.

Government Accounting also defines the responsibilities of the Accounting Officer, the most senior civil servant in a government department, for the proper operation of the department's management controls. The Accounting Officer may be called before the Public Accounts Committee in order to account for the economy, efficiency, and effectiveness with which the department's resources have been employed.

The well-established management control systems within the government of the United Kingdom accord well with the INTOSAI *Guidelines for Internal Control Standards*. The NAO's functions are consistent with the Guidelines in covering the adequacy in principle and the effectiveness in practice of government departments' management controls.

Through management letters to departments and through their value-for-money and other reports to Parliament, the NAO highlights inadequacies and weaknesses in management control systems.

⁹ After qualifying as a chartered accountant, the author spent a number of years in industry as an internal auditor before joining the National Audit Office in 1987 where he works as an Audit Manager.

The NAO takes a systematic and structured approach to the evaluation of management controls, with detailed planning arrangements, comprehensive testing procedures, and well-established reporting arrangements. Its approach also provides for placing reliance on those departments with strong management controls, including effective internal audit. This allows the NAO to perform more efficient and cost-effective external audits.

1. Framework for management controls in UK

This introduction summarises the key characteristics of the management control systems in government within the United Kingdom. The main features of these systems are described below under several headings.

Authority for management controls

The legislative basis for parliamentary control of expenditure is the Exchequer and Audit Department Acts of 1866 and 1921. Detailed management controls are not laid down in the legislation, but it provides a basis for systems to be developed and refined over time.

Role of the central agencies

Within the United Kingdom, the main bodies concerned with management control systems in government are the Treasury, the National Audit Office (NAO) and the Public Accounts Committee.

The Treasury is the government department responsible for managing the country's public revenues and has prime responsibility for determining how public expenditure as a whole should be controlled.

The NAO, headed by the Comptroller and Auditor General, is the country's supreme audit institution and, as such, has responsibility for the external audit of public expenditure by central government.

The Public Accounts Committee is made up of members of Parliament. Its composition reflects that of the political parties in the House of Commons, the elected chamber of Parliament. The Committee is responsible, on behalf of Parliament, for overseeing that proper control is maintained over the expenditure of public funds.

The Comptroller and Auditor General is totally independent of government. He is appointed as an Officer of the House of Commons on a motion addressed to the House by the Prime Minister acting in agreement with the Chairman of the Public Accounts Committee, by tradition a member of the main opposition party. The Comptroller and Auditor General reports to Parliament via the Public Accounts Committee; neither he nor his staff are civil servants accountable to government ministers. He appoints the staff at the NAO and determines their number, gradings, remuneration, and other conditions of service. The majority of his 750 staff are either qualified accountants or training for professionally recognised accountancy qualifications.

The NAO's costs are funded by Parliament. A commission, consisting entirely of members of Parliament, examines the NAO's financial plans and presents the agreed budget for parliamentary approval. The commission also appoints an independent auditor from the private sector to examine the NAO's accounts and to carry out value-for-money investigations of the NAO's own activities.

Development and promulgation of management controls

It is the responsibility of the Treasury to develop and promulgate standards for management control systems within government. The principal means by which this has been achieved has been the establishment of a manual, *Government Accounting*, which serves as a guide on accounting and control procedures for the use of government departments.

The manual sets out the principles governing management control systems over the whole range of government activities and provides detailed information on the form in which departments are required to produce their accounts. It also defines the responsibilities, including those relating to management control, of the Accounting Officer, who is the most senior civil servant in a government department or agency and whose duty it is to serve the minister in charge.

The essence of an Accounting Officer's role is personal responsibility for the propriety and regularity of the public finances for which he or she is answerable, for the keeping of proper accounts, for prudent and economical administration, for the avoidance of waste and extravagance, and for the efficient and effective use of all the available resources.

An Accounting Officer may be called before the Public Accounts Committee in order to account for the economy, efficiency, and effectiveness with which the department's resources have been employed in discharging its functions.

In accordance with the manual, the Treasury issues each Accounting Officer with a memorandum describing these and other responsibilities. The manual also provides detailed guidance to assist the Accounting Officer to fulfil the responsibilities outlined in the memorandum.

Of particular importance for management control in government, the memorandum lays down the procedure to be followed when a minister overrules an Accounting Officer's advice on an issue either of propriety or regularity or relating to the Accounting Officer's wider responsibilities for economy, efficiency, and effectiveness. The relevant papers have to be sent to the Comptroller and Auditor General who may, in turn, report the matter to the Public Accounts Committee.

The memorandum also requires the Accounting Officer to establish an internal audit function.

Monitoring and evaluating management control systems

As well as promulgating standards of management control, it is for the Treasury to monitor performance against them and to promote best practice. But this is not done in detail since the implementation of Treasury guidance is very much left to departments and agencies. Nevertheless, the Treasury requires departments to seek its approval on matters such as budgetary over-spends and cases of fraud and before committing expenditure on major projects.

Resources, skills, and training for implementing management control systems

Departmental staff are engaged under the Civil Service Pay and Conditions and Service Code. This details all of the terms and conditions under which civil servants are employed, including such matters as engagement, promotion, and dismissal as well as provision for training.

The memorandum of the Accounting Officer's responsibilities also states that "an Accounting Officer must make sure that arrangements for delegation promote good management and that he or she is supported by the necessary staff with an appropriate balance of skills. The latter requires careful selection and development of staff and the sufficient provision of special skills and services."

Comparison with INTOSAI Guidelines

The United Kingdom has well-established standards for management control systems in central government which accord well with the INTOSAI Guidelines. The sections that follow provide more details on:

- the role of the NAO in testing the quality of management control systems in government and promoting their use;
- the relationship between the NAO, the Public Accounts Committee, and the Treasury in encouraging good practice in this area, including promulgating and evaluating standards;
- techniques of auditing management control systems;
- the perceived value of management control systems to the NAO, the Public Accounts Committee, and the Treasury.

2. The role of the National Audit Office

This section considers the NAO's role in testing the quality of management control systems in government and promoting their use.

The NAO was created by the National Audit Act of 1983. However, public sector auditing in the United Kingdom has a long history. The first Comptroller General of the Exchequer was appointed in 1314, and the Office of the Comptroller and Auditor General -- of the Exchequer and Audit Department and forerunner of the NAO -- was established in 1866.

Today, the NAO's prime concern is accountability to Parliament for the proper and efficient collection and spending of public funds and for the management of resources. This is done by providing assurance to Parliament, account by account, that money is spent for the purposes intended by Parliament and is properly accounted for. The NAO also reports to Parliament, in selected cases, on the value obtained for that money.

In carrying out its audit work, the NAO seeks to meet these objectives by helping government departments to improve financial control and obtain better value for money.

The NAO's resources are equally divided between their financial audit work and their value-for-money examinations. Both types of work involve testing management control systems and promoting their improvement.

Financial audit

The financial audit work of the NAO covers the certification of the accounts of all government departments, executive agencies, and a wide range of other public bodies. In addition, the NAO audits a number of international accounts, including some prepared by United Nations agencies. Although this paper concentrates, for illustrative purposes, on the work that the NAO undertakes in the audit of government departments, there have been, over the last 13 years, some fundamental reforms in the United Kingdom in the way government has carried out its work. These changes have had an impact on the exercise of management controls within government and on the direction and emphasis of the NAO's own work.

The trigger for these reforms was the introduction of the Financial Management Initiative in 1982. Its aim was to improve management in government by ensuring that all managers knew what their objectives were and how their achievements would be assessed, had well-defined responsibilities for making the best use of their resources, and the necessary information, training, and advice to exercise their responsibilities effectively.

There then followed the "Next Steps" initiative in 1988, which aimed to deliver services more efficiently and effectively within the available resources for the benefit of taxpayers, customers, and staff through the progressive creation of agencies to carry out the executive functions of the government. Central to this initiative has been:

- the belief that government departments should concentrate on strategic management rather than day-to-day "hands on" control;
- the appointment of the right chief executives for the agencies, from within or outside of the civil service, for the job to be done;
- the encouragement of the full use of managerial freedom and incentives by both departments and agencies, with maximum possible delegation of their operation to local management;
- the establishment, for each agency, of a framework document which sets out the aims and objectives of the agency and its expected output and outcomes in terms of both quantity and quality, with explicit performance indicators.

With executive agencies now directly employing the majority of all civil servants, and with the growth of other non-departmental public bodies, there has been increasing concern about maintaining proper standards in the conduct of public business.

During this time of change, the NAO, via the Public Accounts Committee, has reported on a number of serious failures in administrative and financial systems and controls within departments and other public bodies. Thus, in 1994, the Public Accounts Committee published a report, *The Proper Conduct of Public Business*, which summarised these failings alongside a checklist of points which public bodies need to keep in mind in order to guard against the risk of such lapses in future. The report groups failures under the following four headings:

- inadequate financial controls;
- failure to comply with rules;

- inadequate stewardship of public money and assets;
- failure to provide value for money.

One of the more commonly observed failures noted under the penultimate heading was the failure by government departments to establish effective monitoring of non-departmental public bodies which they fund and sponsor, which led to failure to detect waste and irregularities. In response, the checklist indicates that departmental Accounting Officers should identify the key information they need on how non-departmental public bodies conduct their business, and ensure that they obtain and use it.

In another example of the potential impact of devolved administration on management controls, reference is made to the danger of agencies with overly dominant chief executives and senior executives. The checklist states that executive agency chairmen and board members should ensure that chief executives and senior executives understand clearly what their individual responsibilities are.

Therefore, as well as undertaking financial audit work leading to the certification of the accounts of departments, executive agencies, and other public bodies, the NAO's work also covers the examination of matters under the above headings which may not have a significant impact on the figures in the accounts but which are important for the safeguarding of public money and the proper conduct of public business.

The audit of a department's accounts is meant to allow the Comptroller and Auditor General to express a written opinion on the department's annual financial statements as to whether departments' accounts properly present the expenditure and receipts of the money voted for their use by Parliament and whether the expenditures and receipts have been applied to the purposes intended by Parliament and conform to the relevant legislation and other governing regulations.

Although the Comptroller and Auditor General's opinion may be affected by weaknesses in management controls, he is not required to give an opinion on those controls as part of the NAO's certification work. But he may draw attention to any weaknesses if these have had an adverse effect on the accounts.

In carrying out this work the NAO:

- obtains sufficient, relevant, and reliable audit evidence in the most cost-effective way to support the audit opinion;
- applies auditing standards based on those of the United Kingdom accountancy profession, taking full account of those issued by the International Federation of Accountants and INTOSAI;
- applies rigorous monitoring of compliance with auditing standards and procedures.

For the purpose of forming an opinion on a department's annual financial statements, it is necessary, in the first instance, to plan the audit of the department's accounts. Among other matters, this exercise requires that the NAO has sufficient knowledge of the department and its activities, including knowledge of the management control system operating in the department.

A good understanding of the department and its activities enables the audit to be efficient and effective and to make it possible to provide the department with constructive advice on management controls. In particular, this requires knowledge of the control environment in which the department

operates. The control environment comprises the conditions under which the department's accounting process and management controls are designed, implemented, and function.

The NAO seeks to conclude whether the control environment is generally conducive to reliable accounting systems and effective management control. Among the important considerations are whether the department has a proper separation of duties and whether it has clearly defined the responsibilities of its staff.

The techniques of auditing management control systems are discussed in greater detail below. However, as part of the audit planning exercise, an assessment is made of the management controls operating within each account area. An account area consists of transactions or balances which have the following characteristics:

- they are generated by the same system and are subject to the same types of control;
- they are capable of verification by the same types of audit tests;
- they have the same propensity to error and degree of sensitivity.

For example, payroll, payments for supplies, cash and bank balances, and sums owed to creditors usually have characteristics which place them in separate account areas.

The extent of the controls operating within each account area, combined with an assessment of the control environment, do much to determine the approach and extent of the audit testing to be undertaken.

If at any stage of the audit process, whether at the planning, testing, or completion stages, fundamental doubts arise about the effectiveness of the accounting system or management controls, they are reported without delay to the department. This usually takes the form of a management letter, addressed to a senior officer, which draws attention to material weaknesses in the accounting and management control systems identified during the audit.

However, matters are raised in management letters only after comprehensive discussions with the department's senior management, including consideration of the cost effectiveness of the proposed recommendations for improving the accounting and financial control systems.

The NAO asks for a reply indicating the actions that the department intends to take as a result of the comments made in the management letter.

Where the NAO identifies material irregularities or misstatements, or where it is unable to obtain sufficient evidence to conclude that these do not exist, the Comptroller and Auditor General qualifies his audit opinion and sets out the reasons in a report to Parliament. The more serious incidents may result in the Public Accounts Committee questioning the Accounting Officer responsible for the expenditure. The Committee's report then identifies those areas where remedial measures are needed.

For example, the Comptroller and Auditor General's report on the department responsible for providing legal aid (payments from public funds to help individuals to meet the cost of legal advice or proceedings) showed that more than one-third of applicants did not provide documentary evidence of their earnings. The NAO also noted that the department did not always comply with the regulations by following up such cases with applicants. In view of the limited evidence of compliance with the regulations

relating to the grant of legal aid, the Comptroller and Auditor General qualified his opinion on the account. Following the NAO's audit, new regulations have been introduced requiring records to be kept of all applications for legal aid, showing the reasons why individual applications were granted or refused.

The NAO's audit of accounts provides Parliament with assurance that: the accounts comply with the appropriate accounting requirements and principles; the figures contained in the accounts are properly stated; the funds have been applied to the services and for the purposes intended by Parliament; and the transactions conform to relevant authorisations.

However, the NAO's financial audit work does not end there. In addition to its examination of accounts, the NAO undertakes work designed to test whether government departments, agencies, and other bodies supported by public funds observe the highest standards of conduct in their financial affairs. Some of this work may culminate in a report to Parliament.

For example, the NAO reported on a fraud involving £175 000 at a company acting as an agent for the Department of National Heritage. This fraud had occurred, in part, because of a fundamental weakness in management controls. The Department reacted quickly, properly, and robustly. As a result much of the money has been recovered and financial control procedures have been strengthened.

Value-for-money examinations

The NAO undertakes value-for-money investigations into economy, efficiency, and effectiveness, which cover all major aspects of expenditure and revenue and the use of resources by government departments. The definition of economy, efficiency, and effectiveness is provided in Section 4. The objectives of the NAO's value-for-money investigations are to:

- establish whether there are sound management control systems in place to ensure economy, efficiency, and effectiveness;
- examine how well these systems and controls operate, and whether they provide management with the necessary information to monitor performance satisfactorily;
- assess, against predetermined criteria, whether value for money is being achieved;
- make recommendations for improving financial control and value for money.

The selection of topics for investigation is based on a systematic review and on-going monitoring of the activities of government departments so as to produce an annual strategic plan identifying potential areas for NAO investigation over a five-year period. The plan concentrates on areas where the largest resources are involved, where value for money is judged most at risk, and where the NAO can add value.

In finalising the resulting programme of work, account is taken of the suggestions made by the Public Accounts Committee. However, the final choice of areas for investigation rests solely with the Comptroller and Auditor General, a fact which underlines the NAO's independence.

Draft reports are discussed with the department concerned, in order to ensure accuracy and completeness and to confirm that the presentation is balanced and fair. The reports aim to be constructive and realistic, backed up by hard evidence, and directed towards practical recommendations. They look forward to improvements and do not dwell solely on past mistakes.

In the 1994-95 financial year, the NAO presented to the House of Commons and published 50 value-for-money reports. These reports examined such matters as hospital catering, defence procurement, and the privatisation of nationally owned corporations.

As an example of one of the many issues raised in these reports, the NAO's report on the government department responsible for border customs and import controls noted their vulnerability to internal fraud because they deal regularly with huge sums of money and with prohibited goods with a ready, but illegal, market, such as drugs, pornography, and firearms. The NAO reviewed internal frauds in the department over a five-year period and the adequacy of the controls designed to prevent and detect internal fraud. The NAO found that the department's controls were good and were working. However, a number of specific recommendations were made in the report, in particular that there should be staff training in the awareness of fraud risks and in examining areas regularly to ensure that they are free from fraud.

The Public Accounts Committee uses the NAO's value-for-money reports as the basis for questioning the department's Accounting Officer on the issues raised in the report. The Committee then publishes its findings, together with recommendations for further action. These often point to the need for improvements to management control systems.

The government responds to the Committee's comments and recommendations by setting out the action they propose to take in a published memorandum issued by the Treasury. The NAO keeps track of action taken and reports back to Parliament if progress is unsatisfactory. This completes the circle of accountability.

3. The relationship between the NAO, the Public Accounts Committee, and the Treasury

This section deals with the relationship between the NAO, the Public Accounts Committee, and the Treasury for encouraging good management control systems, including their promulgation and evaluation.

Fundamental to understanding this relationship is the fact that the NAO is totally independent of government, whereas the Treasury is part of the Executive. This independence allows the NAO to provide, on behalf of Parliament, an important link in the chain of accountability and stewardship of public funds. The Public Accounts Committee works closely with the NAO and uses its reports to press for improvements. The government accepts nearly all of its recommendations.

The Treasury

The NAO's objective is to give assurance, information, and advice to Parliament on the way government departments use and account for taxpayers' money. The Treasury's main function is to manage these funds. Included in the Treasury's key strategic objectives are keeping public spending to a level which is affordable and improves value for money and improving the framework for the effective and efficient management of the public sector.

Central to the Treasury's achievement of these objectives is its aim to maintain a framework for government accounting which makes clear how resources are used and which provides effective accountability to Parliament. That framework is encapsulated in the manual, *Government Accounting*, referred to above. The advice it contains extends over a wide spectrum. For example, it sets out an agreement between the Public Accounts Committee and the Treasury on the need for all the activities of

government departments and agencies to be covered by specific statutory authority. It also includes other procedures agreed with the Public Accounts Committee, for example for notifying Parliament of proposals to enter into contingent liabilities or to make gifts. It also provides guidance on accounting systems and operating procedures which, in the interests of good administration, departments are required to take into account, for example by maintaining registers of outstanding claims.

Responsibility for implementing the management control systems detailed in the manual rests with the Accounting Officers of the individual departments. The work of the department's internal audit unit is an important aid to the Accounting Officer in this task.

The Accounting Officer is required by the Treasury to ensure that arrangements are made for an internal audit service that follows the objectives, standards, and practices set out in the Treasury's *Government Internal Audit Manual*.

Internal audit is an independent appraisal within a department which, by measuring and evaluating the effectiveness of the management control systems, provides the Accounting Officer and other senior staff important information on the operation of the department's management control system.

The head of internal audit should be suitably experienced, of appropriate senior grade, and preferably have a professional qualification relevant to internal auditing. For major spending departments, Treasury approval is required for the appointment; the internal audit unit's terms of reference should also be submitted for Treasury approval.

Subject to the guidance provided in the *Government Internal Audit Manual*, the precise responsibilities of the internal audit unit are determined by the Accounting Officer. The head of internal audit has direct access to the Accounting Officer and can refer audit reports to him or her, for example where significant recommendations have not received adequate attention from the responsible managers. The Accounting Officer is ultimately responsible for ensuring that prompt and effective action is taken on those reports that call for it, and that the risks resulting from any inaction are recognised and accepted.

The Public Accounts Committee

The Public Accounts Committee was set up in 1861 as one of the measures taken to give Parliament better control over the expenditure of public funds. Its remit was to examine and report from time to time on the accounts of the sums granted by Parliament and such other accounts laid before Parliament as the Committee saw fit.

Historically, the primary purpose of the Public Accounts Committee was to satisfy itself on the accounting for and the regularity and propriety of expenditure. The Public Accounts Committee retains its interest in these matters and does pursue them. However, the present-day Committee mainly explores matters related to economy, efficiency, and effectiveness, as set out in the NAO's value-for-money reports.

The Public Accounts Committee is nominated by the House of Commons for the duration of a Parliament. It consists of not more than 15 members, four being a quorum, drawn from all political parties. It has power to send for persons, papers, and records and to make visits outside Parliament. Although it normally confines its examination to government officials, it has on occasion required the attendance of private persons.

The Public Accounts Committee adopts a non-partisan attitude in its work and seeks to work dispassionately; it almost always reaches a unanimous view, whatever the government in power. Although

the Committee has no executive power and can only make recommendations or express opinions, its reports carry considerable weight. In matters affecting parliamentary control of expenditure, its recommendations are usually accepted by the government.

The National Audit Office

The underlying principles of the NAO's relationship with the Public Accounts Committee and the Treasury have been discussed above and in the section on the NAO's role. Of particular importance is the NAO's complete independence from both of the other two bodies.

In seeking to help government departments improve financial controls and obtain better value for money, the NAO evaluates the management control systems of departments, the techniques of which are discussed in Section 4, including the NAO's relationship with the internal audit function of government departments.

As part of the NAO's financial audit, its advice and assistance to government departments help secure improvements in financial management and accountability through day-to-day contacts. Some of the more important issues are dealt with in management letters, of which some 350 were sent in 1994-95.

Another measure of the NAO's effectiveness is the level of acceptance of conclusions and recommendations in the NAO's value-for-money reports and the related reports by the Public Accounts Committee. In 1994-95, the government accepted 95 per cent of the Committee's recommendations.

These recommendations sometimes have implications beyond the case in question. An example, which demonstrates the relationship between the NAO and the Treasury in promulgating standards of management control, relates to a report produced by the NAO on a major overseas development aid project. This report outlined the events leading up to the decision to provide financial aid to the Pergau hydro-electric project in Malaysia. This represented the largest cash sum ever provided for a single scheme by the government department involved. The report's central issue focused on the Accounting Officer's role in seeking value for money. In this case, the Accounting Officer emphasized to the Minister that his responsibility was to ensure that aid funds were administered in a prudent and economical manner. He believed that providing funds for the Pergau hydro-electric project would not be consistent with this. He therefore concluded that the project should not be supported. Nevertheless, the Minister decided that support should be provided because of the commitments given by the United Kingdom and directed the Accounting Officer to incur the expenditure.

Following the Public Accounts Committee's report on the Pergau hydro-electric project, the government accepted that where a minister overrules the advice of an Accounting Officer on the economy, efficiency, and effectiveness of spending, the relevant papers should be passed to the Comptroller and Auditor General without undue delay. This was a significant change.

To end this section, it is important to note the impact of the European Union on management controls. European Community legislation is subsumed into that of the United Kingdom. Most frequently, it is implemented through a statutory instrument laid before Parliament under the European Communities Act. In some cases, however, new Community law is incorporated in a draft Bill which amends existing national legislation.

Accordingly, the NAO's audit of management controls relating to United Kingdom legislation will also ensure compliance with that of the European Union. A relatively well-publicised example of this was the government's sale in 1988 of the then state-owned vehicle manufacturer Rover Group plc to British

Aerospace plc. A value-for-money audit of the sale by the NAO revealed that the sale had involved additional government subsidies worth £38 million which had not been reported to the European Commission as required before granting state aid to industry.

The extent of these additional subsidies and the failure to obtain prior approval was reported by the NAO through the Public Accounts Committee. It was left to the Commission to decide whether any monies received by British Aerospace in respect of these subsidies should be returned to the government. Eventually the European Court of Justice ruled that they should be.

4. Techniques of auditing management control systems

This section looks at the techniques of auditing management control systems employed by the NAO in its financial audit work and its value-for-money investigations.

Financial audit

The reliance that can be placed on the management control systems of a department is fundamental in deciding the approach to auditing the department's transactions. Therefore, a review of these controls has to be made at the audit planning stage. This requires an assessment of the financial control environment of the department, as follows:

- *Obtaining background information:* Organisational overview; geographical locations; type of operating systems (manual, computerised); and details of computerised functions (computer make/model, computer programme details, reliability of the systems, details of financial applications).
- *Detailing the key features of the account environment:* External environment (legal and regulatory framework, oversight by Parliament/ministers, existence of competition for the business provided, etc.); organisation and management (defined levels for expenditure authorisation, separation of duties, etc.); and organisation culture and personnel (management of staff, training, recruitment and retention, etc.).
- *Assessing the financial controls:* Yes/no answers are required to a series of questions concerning transaction processing and covers: input controls (e.g. do manuals detail procedures for the authorisation of all transactions?); processing controls (e.g. are there procedures to ensure that all transactions have been accurately processed?); output controls (e.g. is out-turn compared against budgets?); computer security controls (e.g. is physical access to terminals and computer rooms adequately controlled?); and controls over subsequent changes (e.g. are systems updates fully tested prior to implementation?). Based on the answers to these questions, the auditor assesses whether the financial control environment is very strong/strong/satisfactory/poor.
- *Describing the accounting system:* The auditor briefly records the accounting systems and then has to answer two key questions: Are proper accounting records maintained? Do the systems provide an adequate audit trail (the sequence of connected pieces of evidence demonstrating how figures being audited have been derived from the original transactions)?

- *Identifying the account areas:* The auditor has to identify each separate account area in the department and verify, by testing a small number of transactions in each, that these are accounted for in accordance with the systems described above.
- *Identifying the key controls:* The auditor should identify the key controls that operate for each account area within the department. For example, the payments area is likely to have the following key controls: reconciliation of invoices to payment; all transactions authorised by a proper signatory; supervisory checks on cheques and supporting documentation; bank account reconciliations; and strictly controlled access to blank cheques.
- *Identifying serious control weaknesses:* Drawing upon the work carried out above, the auditor should identify any serious control weaknesses, for example, the lack of any key controls in an account area. At this stage, consideration is given to whether a management letter should be sent to the department's Accounting Officer highlighting any serious control weaknesses and the likely impact these might have on the scope of the audit, for example, in areas where there is an insufficient audit trail.

Based on this work, the auditor is required to make an initial evaluation of management controls in each account area and their capacity to prevent material error. A matter is defined as "material" if its omission or misstatement would be of concern to Parliament, as the addressee of the Comptroller and Auditor General's opinion on the department's financial statements.

This assessment of the strength of the management controls, plus an evaluation of the likelihood of material error occurring, is used to decide which approach the NAO will take in auditing the transactions of each account area.

On the basis of the results of the audit planning exercise, the NAO may decide that strong controls and low risk of material error enable them to undertake a more cost-effective audit by placing reliance on management controls.

The work of the department's internal audit unit may also influence the NAO's decision on whether to rely on management controls. For example, if internal auditors perform tests of management controls that show the reliability of accounting systems, and if the NAO can test a portion of their work, it will generally be more efficient to adopt a controls-reliance strategy for the audit. In such a case, the auditor needs evidence that internal audit has carried out sufficient work to allow the auditor to rely on its results.

These procedures include obtaining evidence of: the professional standing, independence, and objectivity of the internal auditors; the scope and work of the internal auditors; the adequacy of the work carried out; the relevance to the NAO audit objectives; and the relevance to the year of account.

If a case can be made for a cost-effective audit that relies on the department's management controls, the operation of such controls has to be tested before the NAO can reduce the level of substantive testing that would otherwise be undertaken.

The testing of management controls for compliance seeks to provide audit evidence that internal management control systems are being applied as prescribed. Substantive testing seeks to provide audit evidence of the completeness, accuracy, and validity of the information contained in the accounting records or financial statements of the department being audited.

The results of the NAO's testing of the department's management control systems for compliance may indicate that these controls are not operating as effectively as intended. In this case, the NAO may have to revise the initial evaluation of management controls made in their audit planning exercise. Additional substantive testing will have to be undertaken in order to compensate for the lack of controls, and serious control weaknesses detected in either testing should be notified to the department's Accounting Officer in a management letter.

Management control systems are also audited through other work undertaken by the NAO. This is an extension of the NAO's financial auditing of government accounts. It requires, for example, the on-going monitoring of departments to ensure that they are complying with statutory and other regulations, including the guidance provided in *Government Accounting*.

Where such monitoring indicates the need for more in-depth testing, the auditor reviews such areas as, for example, the risks to probity, legality, and regularity in the custody and control of assets.

The results of such examinations would normally be reported to the department's Accounting Officer, as in the case of the management letters sent as a result of the NAO's accounts audit work.

Value-for-money examinations

Although the NAO's financial audits may involve issues dealing substantively with financial controls, its value-for-money examinations are particularly concerned with these matters, by analogy with the broader interpretation of "management control" set out in the INTOSAI *Guidelines for Internal Control Standards*.

The National Audit Act 1983 provides that the Comptroller and Auditor General may undertake examinations into the economy, efficiency, and effectiveness with which government departments have used their resources in discharging their functions. However, the Act does not define what it means by economy, efficiency, and effectiveness. The definitions used within the NAO draw upon the inter-relationships between:

- Objectives: What a department is trying to achieve.
- Inputs: The financial, human, and physical resources a department uses or consumes.
- Activities: The functions through which a department converts its resources into outputs.
- Outputs: The product of activities in terms of goods, services or other results.
- Impact: The effect of outputs on the direct achievement of objectives, and their wider effects on other programmes or projects or other areas.

Economy, efficiency, and effectiveness are defined as follows:

- Economy: Minimising the cost of resources used for an activity, having regard to appropriate quality.
- Efficiency: The relationship between output, in terms of goods, services, or other results, and the resources used to produce them. An efficient activity maximises output for a given input, or minimises input for a given output.
- Effectiveness: The extent to which objectives have been achieved and the relationship between the intended impacts and actual impacts of an activity.

As part of its objectives in value-for-money examinations, the NAO establishes whether there are sound management control systems in place, and how these systems and controls operate within government departments to ensure economy, efficiency, and effectiveness. Failure in management controls may result in poor value for money being achieved by the department under review.

As well as questioning whether there is evidence of poor value for money, the NAO's choice of topics for investigation includes selection criteria such as:

- How much money is involved?
- Can it be audited?
- Is there parliamentary and/or public concern?
- What is the risk of failure to investigate?
- Is the timing right?
- Will the investigation make a difference/impact?

Ultimately, it is for the Comptroller and Auditor General to decide on the selection of topics for examination. Once a subject is selected, a detailed planning exercise is undertaken in order to achieve a systematic approach to the audit. This value-for-money planning exercise is part of a preliminary study of the subject under examination.

At this stage, it is necessary to identify, in broad terms, the potential weaknesses in the main systems of control or departmental procedures and, using this information, to assess the likely results and findings of a full audit investigation and the prospects for an effective report.

The preliminary study sets out the methodology to be employed and ascertains the nature and availability of the evidence required to support the full investigation. It also considers what the NAO hopes to achieve from the proposed full investigation, and its contribution to significant value-for-money gains in the department concerned. These considerations help to decide whether a full investigation is justified.

On undertaking a full investigation, the NAO ensures that the evidence collected in its fieldwork is:

- Relevant: Information should be based on the latest data available and must have a logical, sensible relationship to the matter in question.
- Reliable: Evidence should be the most accurate, valid, and complete obtainable through the use of reasonable audit methods.
- Sufficient: Evidence should be sufficient to lead a reasonable person to the same conclusions as the auditor.

All of the following categories of evidence obtained by the value-for-money auditor may be relevant to the management control systems operating within a department to ensure economy, efficiency, and effectiveness:

- Documentary: Evidence from file papers, management reports, ministerial submissions, operating manuals, staff instructions, etc.
- Analytical: Evidence obtained by examining and making judgements about data collected in the course of audit work, for example, comparisons, surveys, and samples as well as facts and figures obtained from a variety of quantitative techniques.
- Testimonial: Evidence obtained from others through oral or written statements received in response to audit enquiries or through interviews. It may include statements by departmental officials giving explanations, justifications, lines of reasoning and intention.
- Physical: Evidence obtained through direct observation of people, property or activities.
- File examination: A primary source of documentary evidence is the examination of departmental files and papers.
- Analysis: Involves taking evidence already gathered and reformulating it to produce fresh evidence, using techniques such as statistics and computer modelling.
- Interview: The means used for collecting testimonial evidence. Where oral evidence is significant to the investigation, it will require written confirmation of the record of the interview from the interviewee.
- Observation: The record of physical evidence obtained by observation. It may also require corroborative evidence such as photographs.
- External papers: Papers originating from outside of the audited department may also provide a valuable source of documentary evidence. Examples include published economic analyses and reports from the government's statistics office, the European Union, the OECD, the United Nations, other countries' supreme audit institutions, etc. It is often valid to use overseas sources and comparisons as well as those available within the United Kingdom.

- Specialist assistance: The scope and penetration of value-for-money examinations can be enhanced by the use of specialists in the topics under investigation. Possible sources include consultancy firms, academics, professional bodies, research organisations, and selected individuals.
- Market research: This involves commissioning a survey by a specialist firm or carrying out a survey using NAO staff. It can provide useful evidence on the results achieved by the government departments' programmes or projects, particularly where the intended impact is directed towards defined or identifiable groups.

5. The perceived value of management control systems

This section looks at the perceived value of management control systems to the Treasury, the Public Accounts Committee, and the NAO. It is clear from what precedes that, without satisfactory management control systems, Accounting Officers may not become aware of serious errors and irregularities within their departments.

The NAO gains from strong management controls, including an effective internal audit unit, within an audited department, because reliance on these controls allows it to undertake a more efficient and cost-effective external audit. One way of demonstrating the value of management controls is to consider the impact when such controls are inadequate or fail. The consequence of weaknesses in management control systems can be illustrated by examples taken from recent work of the NAO. These examples can best be grouped around the general objectives promoted by management controls.

The INTOSAI Guidelines (I, para. 3) define management controls as those that provide reasonable assurance that the following four general objectives are achieved:

...promoting orderly, economical, efficient, and effective operations and quality products and services consistent with the organization's mission;...

The NAO's value-for-money report on the Ministry of Defence's management of a works programme for the expansion of submarine facilities found that the final cost had increased by 72 per cent in real terms (some £800 million) and that completion had been delayed by 12 months. The NAO's report cited a number of management control weaknesses as contributing to the increased cost and delays. For example, more attention should have been given to controlling design changes, in particular by assessing their cost implications. The awarding of contracts on the basis of incomplete designs undermined cost control. The Public Accounts Committee concluded that a number of key lessons are equally applicable to other government department projects. These include establishing from the outset an integrated management structure with clearly defined lines of communication, adequate reporting arrangements, and strong control. The Public Accounts Committee also recommended strong discipline over costs and closely monitoring payments to contractors against physical performance.

...safeguarding resources against loss due to waste, abuse, mismanagement, errors, and fraud and other irregularities;...

One of the NAO's main findings from its financial audit of the department responsible for customs and import controls was that increased cross-border shopping in 1993 had led to a reduction in revenue of £200 million. These losses arose from legitimate imports for personal consumption. However, a small but

significant further loss arose from the importing and illegal resale of tobacco products and alcoholic drinks without payment of United Kingdom taxes. The department is responding to the situation by deploying tax verification officers to seek out and prosecute those engaged in this type of smuggling.

...adhering to laws, regulations, and management directives;...

The NAO's financial audit of the 1993-94 Health Department accounts showed failure to adhere to regulations and resulted in the Comptroller and Auditor General qualifying his audit opinion. He said that payments to staff for employment termination settlements may prove to have been beyond the health authorities' powers.

...developing and maintaining reliable financial and management data and fairly disclosing that data in timely reports.

Of fundamental importance to the Treasury, the Public Accounts Committee, and the NAO is the requirement that departments should maintain accurate and complete accounting records of all their transactions. Failure to maintain proper books of account would mean that Parliament could have no confidence in the accuracy of the departments' annual financial statements. Accordingly, there would be no means of ensuring that money allocated to departments had been used as intended by Parliament. Fortunately, there have been no occasions, in modern times, when the Comptroller and Auditor General has had to qualify a department's financial statements owing to its failure to maintain proper books of account.

6. Conclusion

In conclusion, it is important to remember that the NAO is completely independent of the executive functions of government, including the Treasury. It is for the Treasury to establish the principles of management control and to promulgate them to Accounting Officers.

The responsibilities of the NAO, as the supreme audit institution of the United Kingdom, closely follow the requirements of the INTOSAI Guidelines (I, paras. 80-85). Thus, the NAO, in both its financial and value-for-money audits, assesses the adequacy in principle and effectiveness in practice of government departments' management controls. Through management letters to departments and through value-for-money and other reports to Parliament, the NAO points out inadequacies and weaknesses in management control systems. It operates a systematic and structured approach to the evaluation of management controls, with detailed audit planning arrangements, comprehensive testing procedures, and well-established reporting arrangements.

It is clearly in the NAO's interest to ensure that government departments operate with strong management controls, including effective internal audit units, as reliance on these controls allows the NAO to perform more efficient and cost-effective external audits.

ANNEX

INTOSAI

Guidelines for Internal Control Standards

Issued by

**Internal Control Standards Committee
International Organization of Supreme Audit Institutions**

June 1992

PREFACE

Internal control has long been of interest to the members of the International Organization of Supreme Audit Institutions (INTOSAI). This interest can be traced to the 1974 Congress, where discussions were held about the need for internal audit and the importance of internal control systems. Since that time, the interest in internal controls has grown as government management has become more complex. This complexity does not allow management to review the correctness of every individual employee task. Many governments are looking for ways to provide more economical, efficient, and effective services and to control deficits and debt. This often involves reorganizing old structures, revising old procedures, allowing managers more freedom, and increasing reliance on automated technologies. In such an environment, an effective internal control structure can provide reasonable assurance that management's objectives are being achieved.

The Committee on Internal Control Standards was formed to strengthen financial management and establish more focused accountability in the public sector. Its goal is to develop guidance for establishing and maintaining effective internal controls. During the development of this document, the Committee realized that these standards and guidelines can apply to all managers, not just financial managers, and expanded the scope to cover all government operations. Therefore, this document's use of the term "internal control" is not limited to the traditional view of financial and related administrative control, but covers the broader concept of management control.

The following member countries were involved in this project:

- . Austria, Court of Audit;
- . Chile, Office of the Comptroller General;
- . Egypt, Central Auditing Organization;
- . France, Court of Accounts;
- . Jamaica, Office of the Auditor General;
- . Spain, Tribunal of Accounts;
- . Tanzania, Exchequer and Audit Department;

- . United States, General Accounting Office; and
- . Yugoslavia, Social Accounting Service.

The members identified four areas in which they believed guidance was needed to achieve the Committee's goal. These areas are

- . the concepts and objectives of internal controls,
- . a minimal set of internal control standards that any nation could use as a framework to develop a specific internal control structure,
- . the implementation of an internal control structure, and
- . the periodic monitoring of the effectiveness of an internal control structure.

Each member of the Committee researched one of these four areas. The individual research papers were combined into a draft document that the Committee members discussed among themselves and exposed to all INTOSAI members for comment. Those discussions and comments provided the Committee with insight into the use of internal controls by various systems of government.

The Committee discovered that while systems of government vary widely, the standards for strong internal controls are generally the same. This document attempts to capture those standards and present a consensus of the standards desirable in any specific internal control structure. Government management can use these standards to implement an effective internal control structure. Government auditors can use them to help evaluate those structures.

The Committee would like to thank the following countries for sharing their knowledge of and experience in internal controls with us and taking the time to respond to our request for comments.

Australia	Netherlands
Belgium	New Zealand
Belize	Norway
Botswana	Pakistan
Canada	Panama
Colombia	Peru
Costa Rica	Philippines
Czechoslovakia	Portugal
Denmark	Qatar
Finland	St. Lucia
Germany	Sierra Leone
Haiti	South Africa
Hungary	Switzerland
India	Tunisia
Ireland	Turkey
Italy	United Kingdom
Mauritania	Yemen
Mexico	Zimbabwe

After incorporation of the comments, the Governing Board approved the issuance of these Standards at its 35th meeting (October 1991, Washington, DC). This is a "living" document that reflects the current trends in designing, implementing, and evaluating internal control structures.

Charles A. Bowsher
Comptroller General of the United States
Chairman, Internal Control Standards Committee

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OVERVIEW OF INTERNAL CONTROL CONCEPTS, OBJECTIVES AND STANDARDS

1. Internal control is a management tool used to provide reasonable assurance that management's objectives are being achieved. Therefore, responsibility for the adequacy and effectiveness of the internal control structure rests with management. The head of each governmental organization must ensure that a proper internal control structure is instituted, reviewed, and updated to keep it effective.

2. The Supreme Audit Institution also has a responsibility for ensuring adequate internal control. It should encourage and support

- the establishment of detailed organizational internal control structures for each governmental unit based on the standards presented in this document and
- a review of that structure to assure that the controls are working as intended and are adequate to achieve the desired results.

3. As they are ultimately responsible for the adequacy of the internal control structure and its implementation, it is important that managements of all organizational units within government understand the nature of the internal control structure and the objectives internal controls are to achieve. An internal control structure is defined 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.

4. The following standards form the framework for an internal control structure and have been categorized as general standards and detailed standards.

General Standards

Reasonable Assurance: Internal control structures are to provide reasonable assurance that the Standards aforementioned general objectives will be accomplished.

Supportive Attitude: Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.

Integrity and Competence: 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.

Control Objectives: Specific control objectives are to be identified or developed for each activity of the organization and are to be appropriate, comprehensive, reasonable, and integrated into the overall organizational objectives.

Monitoring Controls: Managers are to continually monitor their operations and take prompt, responsive action on all findings of irregular, uneconomical, inefficient, and ineffective operations.

Detailed Standards

Documentation: 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.

Prompt and Proper Recording of Transactions and Events: Transactions and significant events are to be promptly recorded and properly classified.

Authorization and Execution of Transactions and Events: Transactions and significant events are to be authorized and executed only by persons acting within the scope of their authority.

Separation of Duties: Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions and events should be separated among individuals.

Supervision: Competent supervision is to be provided to ensure that internal control objectives are achieved.

Access to and Accountability for Resources and Records: 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.

5. These standards would be applicable to all governmental organizational units. They can be viewed as the minimum acceptable standards that organizations follow when instituting internal controls and provide criteria for auditors when auditing the internal control structure.

6. The standards presented here are not new ideas. Many of them are currently incorporated in government operations. Their presentation as a framework, however, may be new. The remainder of this document discusses in greater detail the definition and limitations of internal control, the standards of internal control, the establishment of the framework for internal controls, and the implementation and monitoring of internal control structures.

DEFINITION AND LIMITATIONS OF INTERNAL CONTROLS

Definition and Objectives

7. Internal control structures are defined as the plans of an organization, including management's attitude, methods, procedures, and measures that provide reasonable assurance that the objectives are being achieved. Those objectives are

- 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 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.

8. This definition of internal control structures and the objectives for them are intentionally broad in scope to cover all government operations. However, internal controls have been organized and defined in various other ways. The following descriptions have been provided as a point of reference.

9. When describing internal controls by their role in the organizational structure, they have often been organized into the broad categories of management, administrative, and accounting controls. Management controls are often viewed as encompassing all controls. They are the framework of the organization -- all the plans, policies, procedures, and practices needed for employees to achieve the entity's objectives. Administrative controls are those procedures and records concerning the decision-making processes that lead employees to carry out authorized activities in achieving the organization's objectives. Accounting controls cover the procedures and documentation concerned with the safeguarding of assets and the reliability of financial records.

10. Internal controls have also been categorized by their intended purpose: to prevent errors (for example, by segregating duties and authorization requirements); to detect errors (for example, by establishing production standards to detect variances in actual results); to correct errors that have been detected (for example, by collecting an overpayment to a vendor); or to compensate for weak controls where the risk of loss is high and additional controls are needed.

11. In practice, the distinction among these categories and types is often difficult to recognize because an effective internal control structure requires elements of each. Even the descriptions of each category of control can vary among individuals. However, regardless of how internal controls are organized or defined, they should not be thought of as alternatives to each other. They should be complementary. Any one control has advantages and disadvantages, so an effective internal control structure uses a mix of controls to compensate for the particular disadvantages of individual controls.

12. To be effective, internal controls must satisfy three basic criteria:

- They must be appropriate (that is, the right control in the right place and commensurate to the risk involved).
- They must function consistently as planned 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).
- They must be cost effective (that is, the cost of implementing the control should not exceed the benefits derived).

Limitations on Internal Control Effectiveness

13. No internal control structure, however detailed and comprehensive, can by itself guarantee efficient administration and complete and accurate records or be foolproof against fraud, especially when those involved hold positions of authority or trust. Internal controls dependent on the segregation of duties can also be rendered ineffective where collusion by several individuals is involved. Also, authorization controls can be abused by the person in whom the authority is vested, and management is frequently in a position to override the controls it has established. To maintain an internal control structure that would eliminate the risk of loss is not realistic and would probably cost more than is warranted by the benefit derived.

14. Because any internal control structure depends on the human factor, it is subject to flaws in design, errors of judgment or interpretation, misunderstanding, carelessness, fatigue, or distraction. While the competence and integrity of the personnel designing and operating the system may be controlled by selection and training, these qualities may alter due to pressures from within and outside the agency. Furthermore, no matter how competent the staff, the control they operate may become ineffective if they do not correctly understand their function in the control process or choose to ignore it.

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

DISCUSSION OF THE INTERNAL CONTROL STANDARDS

16. The establishment of demanding internal control standards is necessary, particularly in government, in view of its size; diversity; the volume of transactions; the multiplicity of records; and numerous rules, regulations, and laws. Because statutory provisions govern the management and control of public resources and public programs, standards that govern and ensure such compliance are required.

17. Internal control standards are separated into two categories: general standards and detailed standards. Together, they define the framework for the minimum level of acceptability for an internal control structure in operation. They should be used as the criteria for both developing and evaluating internal controls. These internal control standards apply to all management, operational, and administrative functions and should not be limited to financial operations. They also apply to all systems, whether automated or manual.

General Standards

18. The general standards consist of reasonable assurance, supportive attitude, integrity and competence, control objectives, and monitoring controls. Together, they provide the proper control environment within the organization.

Reasonable Assurance

19. Internal control structures are to provide reasonable assurance that the general objectives will be accomplished.

20. 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.

21. Reasonable assurance recognizes that the cost of internal control should not exceed the benefit derived. Cost refers to the financial measure of resources consumed in accomplishing a specified purpose and the economic measure of a lost opportunity, such as a delay in operations, a decline in service levels or productivity, 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.

22. 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. 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, and diluted responsibilities may make it difficult to identify accountable individuals. Thus, benefits derived from excessive controls in one area may be outweighed by increased costs in other activities.

23. An example of inefficient operations follows. A government agency's field office is responsible for a construction project for homeless individuals. However, every variation from the original contract, regardless of its technical or financial impact, must be approved by headquarters with the objective of controlling cost and product quality. This slows down the construction project's progress, which may increase costs and harm one or more of the individuals whom the construction was intended to benefit. To improve efficiency, headquarters could delegate the authority for minor contract changes to the field office. The headquarters' office would still have adequate control of the construction costs and quality while reducing delays.

Supportive Attitude

24. Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.

25. Attitude is established by top management and is reflected in all aspects of management's actions. The involvement and support of top government officials and legislators will foster a positive attitude. This attitude will also be fostered by managers committed to achieving strong controls through actions concerning agency organization, personnel practices, supervision, communication, protection and use of resources through systematic accountability, monitoring and reporting systems; seeking improvement suggestions from employees at all levels; and general leadership. Management can demonstrate its support for good internal controls by emphasizing the value of independent and objective internal auditing in identifying areas for improving performance quality and by responding to information developed through internal audits.

26. Employees must follow internal controls and take steps to promote the effectiveness of the controls. A supportive attitude will affect performance quality and, as a result, the quality of internal controls. When internal controls are a consistently high management priority, management initiates and fosters a positive and supportive attitude.

27. In the final analysis, the commitment by management in setting "the tone at the top" is critical to maintaining a positive and supportive attitude towards internal controls in an organization.

Integrity and Competence

28. 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.

29. Managers and their staffs must maintain and demonstrate (1) personal and professional integrity and ethical values, (2) a level of skill necessary to help ensure effective and efficient performance, and (3) an understanding of internal controls sufficient to effectively discharge their responsibilities.

30. Many elements influence the integrity of managers and their staffs. The tone at the top is important. Personnel should periodically be reminded of their obligations under an operative code of conduct that comes from top management. Counseling and performance appraisals are also important. Overall performance appraisals should be based on an assessment of many critical factors, including the implementation and maintenance of effective internal controls.

31. Hiring and staffing decisions should include assurance that individuals have the proper education and experience to carry out their assigned jobs. Once on the job, the individual should be given the necessary formal and on-the-job training. Managers and employees who possess a good understanding of internal controls and are willing to take responsibility for them are vital to an effective control structure.

Control Objectives

32. 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.

33. The objectives are the positive effects that management tries to attain or the adverse conditions/negative effects that management seeks to avoid. The objectives should be tailored to fit the specific operations in each activity while being consistent with the overall internal control objectives, similar to those presented in paragraph 7, which would be set forth by a central department/ministry or in legislation.

34. To develop specific control objectives, all operations should be grouped first into broad categories. Then, within each broad category, operations should be grouped into one or more sets of regularly recurring activities (such as identifying, classifying, recording, and reporting information) that are required to process a particular transaction or event. These groupings should be compatible with the organizational structure of the entity and its division of responsibilities.

35. Agency operations can often be broadly categorized as follows:

- **Management** activities cover the overall policy and planning, organization, and audit functions.
- **Program (operational)** activities are those that relate to the agency's mission(s).
- **Financial** activities cover the traditional control areas concerned with budgets, the flow of funds (revenues and expenditures), related assets and liabilities, and financial information.
- **Administrative** activities are those that provide support to the agency's primary mission, such as library services, mail processing and delivery, printing, and procurement.

36. To develop the control objectives, the sets of recurring activities must be identified and analyzed. For example, the recurring activities associated with the procurement of materials (an administrative activity), would include (1) identifying needed items, (2) selecting a vendor, (3) contracting for the items, (4) receiving the items, and (5) checking for quality. One of the control objectives to be achieved here could be that only those requests for materials that meet management's criteria should be approved. Another may be that only requested materials should be accepted.

37. Obviously, the broad categories mentioned above interact, and control objectives over this interaction must also be established. For example, while the above example was considered an administrative activity, payment for the materials is a financial activity and the use of the materials may be a program activity. The categories would need to interface to properly control and record the payment.

Monitoring Controls

38. Managers are to continually monitor their operations and take prompt, responsive action on all findings of irregular, uneconomical, inefficient, and ineffective operations.

39. Monitoring operations ensures that internal controls are achieving the desired results. Monitoring of operations should be built into the methods and procedures managers select to control operations and ensure that the activities meet the objectives of the organization. Monitoring includes addressing audit findings and recommendations reported by internal and external auditors to determine what corrective actions are needed.

Detailed Standards

40. Detailed standards are the mechanisms or procedures by which control objectives are achieved. They include, but are not limited to, specific policies, procedures, plans of organization (including separation of duties), and physical arrangements (such as locks and fire alarms). Controls must provide reasonable assurance that the internal control objectives are being achieved continually. To do so, they must be effective and efficient and be designed to work together as a system, not individually.

41. To be effective, controls should fulfill their intended purpose in actual application. A set of controls designed to operate in a manual environment may not be effective in an automated environment. Therefore, the controls selected should provide the coverage they are supposed to provide and operate when intended. As for efficiency, controls should be designed to derive maximum benefit with minimum effort. Controls tested for effectiveness and efficiency should be those in actual operations and should be evaluated over time to ensure that they are continually used.

42. The following controls are those widely used in designing an orderly and effective internal control structure. The specific methods and procedures discussed within each are not exhaustive but are used as examples.

Documentation

43. 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.

44. An organization must have written evidence of (1) its internal control structure, including its objectives and control procedures, and (2) all pertinent aspects of significant events and transactions. Also, the documentation must be available and easily accessible for examination by appropriate personnel and the auditors.

45. Documentation of the internal control structure should include identification of an organization's structure and policies and its operating categories and related objectives and control procedures. These should appear in documents such as management directives, administrative policies, procedures manuals, and accounting manuals.

46. 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.

47. Documentation of the internal control structure, transactions, and significant events must have a clear purpose, contribute to achieving the organization's objectives, and be useful to managers in controlling their operations and to auditors or others involved in analysing operations. Documentation without a clear purpose will hinder the efficiency and effectiveness of an organisation.

Prompt and Proper Recording of Transactions and Events

48. Transactions and significant events are to be promptly recorded and properly classified.

49. Transactions and events must be promptly recorded when they occur if information is to maintain its relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event, including (1) the initiation and authorization, (2) all stages while in process, and (3) its final classification in summary records. It also applies to promptly updating all documentation to keep it relevant.

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

51. Prompt and proper recording of information is essential for assuring the timeliness and reliability of all information used by the organization to support its operations and decision-making.

Authorization and Execution of Transactions and Events

52. Transactions and significant events are to be authorized and executed only by persons acting within the scope of their authority.

53. Management decides to exchange, transfer, use, or commit resources for specified purposes under specific conditions. Authorization is the principal means of ensuring that only valid transactions and events are initiated as intended by management. Authorization, 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 execute their assigned duties in accordance with directives and within the limitations established by management or legislation.

Separation of Duties

54. Key duties and responsibilities in authorizing, processing, recording, and reviewing transactions and events should be separated among individuals.

55. To reduce the risk of error, waste, or wrongful acts and the risk of not detecting such problems, no one individual or section should control all keystages 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, issuing and receiving assets, making payments, and reviewing or auditing transactions. Collusion, however, can reduce or destroy the effectiveness of this internal control technique.

56. A small organization may have too few employees to fully implement this technique. In such cases, management must be aware of the risks and compensate with other controls. Rotation of employees may help ensure no one person deals with key aspects of transactions or events for an undue length of time. Also, encouraging or requiring annual holidays may help reduce risks.

Supervision

57. Competent supervision is to be provided to ensure that internal control objectives are achieved.

58. 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.

59. Assignment, review, and approval of an employee's work requires

- clearly communicating the duties, responsibilities, and accountabilities assigned each staff member;
- systematically reviewing each member's work to the extent necessary; and
- approving work at critical points to ensure that it flows as intended.

60. Assignment, review, and approval of staff's work should result in the proper control of their activities, including (1) following approved procedures and requirements; (2) detecting and eliminating errors, misunderstandings, and improper practices; (3) discouraging wrongful acts from occurring or from recurring; and (4) reviewing for efficient and effective operations. A supervisor's delegation of work should not diminish the supervisor's accountability for these responsibilities and duties.

Access to and Accountability for Resources and Records

61. 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.

62. 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, both of which should be periodically assessed. For example, restricted access to and accountability for highly vulnerable documents, such as check stocks, can be achieved by

- keeping them locked in a safe,
- assigning a sequential number to each document, and
- assigning custodial accountability to responsible individuals.

63. When determining an asset's vulnerability, its cost, portability, exchangeability, and perceived risk of loss or improper use should be considered.

ESTABLISHING THE FRAMEWORK FOR INTERNAL CONTROL STRUCTURES

- 64.** A specific authority should be assigned the responsibility for developing and promulgating a governmentwide definition of an internal control structure, the objectives to be achieved by that structure, and 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 governmental organizations.
- 65.** 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.
- 66.** Wherever the authority is assigned, the Supreme Audit Institution has a vital role to play in the development of the internal control structure. This role will be played directly or indirectly, largely depending on the Supreme Audit Institution's legal mandate and the organizational structure of the country's management system. If the responsibility rests with an authority other than the Supreme Audit Institution, that institution's comments and advice should be sought as a matter of course.
- 67.** Where the Supreme Audit Institution is responsible for promulgating the standards, a clear distinction must be made between these standards and the specific internal control procedures that should be instituted by each organization. The Supreme Audit Institution has a vested interest in ensuring that satisfactory internal controls exist in the organizations it audits. However, it is important and necessary that independence be maintained. The Supreme Audit Institution should therefore not take the responsibility for implementing the specifics of the internal control procedures in any audited organization. This is properly management's job. However, it would be appropriate, and in some countries it is a requirement, for the Supreme Audit Institution to comment on the effectiveness of existing control arrangements and to make recommendations for improvement. This can be done without a loss of independence since the responsibility for deciding on and implementing the control provisions would still rest with the audited organization's management.
- 68.** It may be appropriate for various central organizations to become involved to some extent in setting internal controls to be followed by all agencies. In some instances, the controls may be quite specific (for example, in matters relating to revenue collections, contract award, specifications for computerized information systems, and human resource management). In other areas, especially those dealing with managerial controls, the controls may have to be more general. In either situation, the internal controls must permit the exercise of managerial judgment and initiative aimed at improving economy, efficiency, and effectiveness.
- 69.** The responsible central organization should review its internal control standards and make necessary amendments from time to time. The internal control standards and any amendments must be fully documented and promptly circulated to all organizations to which they apply.

70. When specific internal control standards and procedures are legislatively promulgated, the legislation should not be too restrictive. It should allow managers flexibility in modifying procedures as the operational environment changes. Otherwise, internal controls may become outdated and inefficient before the legislation can be amended. The specifics of an internal control structure must be periodically reviewed and adjusted to keep pace with an organization's changing environment.

IMPLEMENTING AND MONITORING INTERNAL CONTROL STRUCTURES

71. The Supreme Auditor should encourage and support management's establishment of internal controls. This can be done by educating management as to its responsibilities for implementing and monitoring the control structures. The Supreme Auditor should also audit those structures to assure that controls are adequate to achieve the desired result.

Management's Responsibilities

72. As stated earlier in this document, internal control is a management tool. It is management's responsibility to implement and monitor the specific internal controls for its operations. Even in countries where specific controls are set out in legislation, a manager has no less a responsibility for implementing and monitoring those controls. All managers should realize that a strong internal control structure is fundamental to their control of the organization, its purpose, operations, and resources. They should accept responsibility for it.

73. To design, establish, and maintain an effective internal control structure, managers should understand the objectives to be achieved. Legislation can provide a common understanding of the internal control definition and objectives to be achieved. It can also prescribe the policies managers are to follow to implement and monitor their internal control structures and to report on the adequacy of those structures.

74. Management often establishes an internal audit unit as part of its internal control structure. While internal auditors can be a valuable resource to educate and advise on internal controls, the internal auditor should not be a substitute for a strong internal control structure.

75. The internal control standards discussed earlier in this document require managers to continually monitor their operations. The quality of internal controls can be more formally assessed by requiring a periodic evaluation and report from managers to ensure that the controls for which they are responsible continue to be appropriate and are working as planned. These periodic management assessments can be mandated in a number of ways. They can become part of management's policies, or they can be mandated administratively by a central oversight organization charged with overall government management responsibility. An effective means, however, is a legislative mandate that requires managers to annually assess their internal controls and report to the legislative body on (1) the effectiveness and efficiency of the internal controls in achieving their goals and objectives and (2) their plans to correct weaknesses identified.

76. Even in countries where specific internal control procedures are legislatively mandated, managers have an obligation to identify ineffective and inefficient controls that may or do cost more than the benefits they are designed to achieve. A periodic management report to the legislative body -- in addition to reports to the organization's management and a central organization -- provides some additional assurance that management is giving internal controls the attention needed to promote efficient and effective operations.

77. These evaluations should be made according to consistent procedures that meet minimum levels of acceptability. Management should have a clear plan for periodically evaluating its internal controls, reporting problems, and correcting weaknesses. The types of procedures that might be considered include (1) segmenting the organization into components; (2) identifying programs and administrative functions within each component; (3) assessing the general control environment and the vulnerability within each program and activity to waste, loss, impropriety, or failure to meet other established objectives; (4) planning and scheduling internal control evaluations of selected programs and functions; (5) evaluating and testing the effectiveness of the internal controls within the selected programs and functions; (6) determining and scheduling corrective action where necessary; and (7) reporting the results of the overall assessment and the corrective action to be taken.

78. Management can also use its internal audit unit to help monitor the effectiveness of internal controls. The closeness of internal auditors to the day-to-day operations usually places them in a position to continually assess the adequacy and effectiveness of internal controls and the extent of compliance. The internal auditors have a responsibility to management for reporting any inadequacies in the internal controls and any failure of employees to adhere to them and recommending areas needing improvement. In addition, they should establish procedures for following up on previously reported internal and external audit findings to ensure that managers have adequately addressed and resolved the matters brought to their attention.

79. As soon as weaknesses are found, corrective action must be taken which could involve several levels of government management. Corrective action may require legislatures to change existing laws, central organizations to revise internal control standards and procedures, and management to revise its internal control structure.

The Supreme Auditor's Responsibilities

80. The Supreme Audit Institution should gear its work toward assessing the adequacy in principle and the effectiveness in practice of existing internal controls in audited organizations. Where these are found to be inadequate, the weaknesses, their causes, and possible effects should be fully documented and promptly communicated to the audited organization. When discussing controls with management, the auditor may want to use the term "management control" instead of "internal control" to reinforce the notion that control issues are much broader than traditional financial controls. Recommendations should also be made both formally and informally on how to correct the situation. Before making these recommendations, the Supreme Audit Institution should seek the audited organization's views and strive to ensure that the recommendations are relevant and practical. In particular, the cost of implementing the proposed control measures should be related to the risk inherent in the prevailing situation.

81. In some countries, private commercial auditors audit certain government organizations. In such cases, these auditors and the professional bodies to which they belong should provide advice and recommendations on the internal controls the audited agencies should implement.

82. When assessing internal controls, the auditors should consider the following steps:

- determine the significance and the sensitivity of the program subject matter for which controls are being assessed;
- assess susceptibility to misuse of resources, failure to attain objectives, and noncompliance with laws and regulations;
- identify and understand the relevant internal controls;
- determine what is already known about control effectiveness;
- assess adequacy of the control design;
- determine, through testing, if controls are effective; and
- report on the internal control assessments and discuss needed corrective actions.

83. The Supreme Audit Institution should ensure that satisfactory internal controls exist in key facets of the auditee's operations. Without satisfactory controls, management may not detect serious errors and irregularities, and the work of the Supreme Audit Institution becomes more difficult because of the increases needed in audit scope, staff, and time. Yet, available time and other resources are unlikely to allow for more than a limited check of projects, operations, and transactions. With weak internal controls and limited audit coverage, many things could go wrong without detection by either management or the Supreme Audit Institution.

84. 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 organization's operations. In some countries, however, the internal audit units may lack independence, be weak, or be nonexistent. In those cases, the Supreme Audit Institution should, whenever possible, offer assistance and guidance for establishing and developing such capability. This assistance might include secondment or lending of staff, conducting lectures, sharing training materials, and developing methodologies and work programs.

85. The Supreme Audit Institution also needs to develop a good working relationship with the internal audit units so that experience and knowledge can be shared and the work of each can be supplemented and complemented. This relationship can be developed by including internal audit observations and recognizing their contributions in the external audit report when appropriate. The Supreme Audit Institution should develop procedures for assessing the internal audit unit's work to determine the extent to which it can be relied upon. A strong internal audit unit could reduce the audit work necessary by the Supreme Audit Institution and avoid needless duplication of work. The Supreme Audit Institution should ensure that it has access to internal auditor reports, related working papers, and audit resolution information.