

CONTROL AND INTERNAL AUDIT

1 Introduction

- 1.1 Effective management and accountability in government depend upon the establishment of a comprehensive internal control framework. There are two features to this internal control framework, namely 'control' and 'internal audit'. However, in some countries this distinction is either not made because the language uses the same terminology to describe what in English are defined as two entirely separate activities, or the two features are confused or there is too much focus on one (usually on 'control') at the expense of the other. There are important distinctions between 'control' and 'internal audit'. 'Control' does not provide the function of 'internal audit' and 'internal audit' does not provide the function of 'control'.
- 1.2 The purpose of this note is to explain the differences and to demonstrate the significance of each to the process of establishing an effective internal control framework.
- 1.3 In English language usage and in a public administration context the word 'control' has two elements. The first element is the set of rules and arrangements by which an organisation administers or manages the activities for which it is responsible. The second element to control is the actual implementation of those rules and arrangements. (Together the rules and arrangements and their implementation represent the 'control system'.)
- 1.4 'Audit' in the same context also has two elements. First, it includes a review (independently of the administrators or managers subject to audit) of the effectiveness of the set of rules and arrangements by which an organisation administers or manages the activities for which it is responsible and secondly, a review of the actual implementation of those rules and arrangements. (The current tendency is for the auditor to audit the 'control system' rather than the individual transactions made.) Audit may also be 'internal' or 'external'. Internal audit reports to the (usually senior) management of the organisation. External audit reports to the owners or external stakeholders of the organisation, such as for central government the Parliament.

2 Responsibilities of management

- 2.1 Managers (or administrators) in line ministries (or the equivalent in other public sector organisations) are responsible for establishing the internal control framework. They may do so in accordance with a specification laid down by a central ministry such as a Ministry of Finance or the equivalent in other public sector organisations. That central ministry or its equivalent should not though itself undertake the internal control function because to do so would remove from the line ministry a primary responsibility of that line

ministry which is to be responsible for the control of its own actions. In a line ministry the manager (or administrator) responsible for the internal control framework normally would be the most senior permanent official.

2.2 However, the reality is that the traditional approach in many countries is for the Ministry of Finance or its equivalent, not to trust the line ministries (or their equivalent) for fear of losing financial control or because they are concerned about the integrity of the administrative processes (perhaps as a response to high levels of fraud or corruption). They therefore go beyond the setting of a framework and seek to 'control', in one way or another, the management and/or activities of the line organisations. This traditional approach tends to generate the following consequences for the Ministry of Finance (or its equivalent):

- a focus on detail;
- concern for individual transactions rather than systems;
- a shift of blame or responsibility from the line organisation to the centre for the adequacy of the 'control' function;
- a lack of management information availability to line management thus lessening the ability of line management to manage tending therefore to confirm to the centre that the line ministry does not have a sufficient management capability and thus reinforcing the argument for the need for central control.

2.3 The results are that:

- control is tight over individual transactions but lacks a perception of the objectives that those transactions are aimed at achieving;
- the central resources are devoted disproportionately to bureaucratic procedures and procedure is a dominant concern;
- distrust is enhanced because of the need to ensure compliance with procedures and where failures are discovered the usual response is to add further rules in turn adding to the bureaucracy;
- line management unable or unwilling to take the 'control' responsibility;
- serious omissions, particularly in reviewing the adequacy of systems;
- a lack of emphasis on value for money review;
- no understanding of the concept of 'materiality' or risk, which means that judgements are not made on the basis of their relative significance to the organisation.

2.4 Line ministry responsibility is to ensure that the service or other activity is properly managed. ‘Proper management’ means that the service or activity is managed;

- in accordance with the budget, the law and any regulations including management directives;
- in a manner that promotes promotes orderly, economical, efficient, and effective operations and achieves planned outcomes;
- safeguards resources against fraud, waste, abuse, and mismanagement;
- provides quality products and services consistent with the organization’s mission, including a focus on the needs of the customer, client or taxpayer rather than on the needs of the bureaucracy;
- develops and maintains reliable financial and management information
- and fairly discloses that data through timely reporting

2.5 Line ministries therefore need the ‘tools’ to enable them to carry through their responsibilities. Line ministries should therefore:

- carry out all ex ante checks of invoices and other payments (this should be 100%). (‘control’); However, this check should be integrated in to the management process and not be an independent control. Also the main control should be over orders/commitments and not the payment of invoices.
- have available an assurance mechanism to enable them to satisfy themselves that controls are working properly (‘internal audit’);
- have available sufficient timely financial and performance information to enable them to manage services with economy, efficiently and effectively (i.e. with a view to achieving value for money) (access to an adequate financial and management information system);
- have the management flexibility to adjust service inputs in order to maximise performance outputs (appropriate delegated authority).

3. **Responsibilities of the Ministry of Finance (or equivalent)**

3.1 The responsibility of the Ministry of Finance (with other central ministries where appropriate) is to create the structures to enable the line ministries to provide services economically, efficiently and effectively. That means ensuring that the budgetary, legislative and bureaucratic framework facilitates this objective.

- 3.2 To complement this an appropriate accountability process is required which includes:
- reporting to the Ministry of Finance by the line ministries so that the Ministry of Finance can satisfy itself that line ministry objectives are being met;
 - reporting to the Parliament or other legislative assembly as the representatives of the taxpayer and the population generally;
 - reporting to the stakeholders (who will include taxpayers, the general public and service users).
- 3.3 A Ministry of Finance will also need its own control and internal audit functions to deal with those responsibilities for which it has a 'line' responsibility. (See Section 7 below.)

4. **What is 'control'?**

4.1 Control is the process by which organisations ensure that actions taken are:

- in accordance with legal requirements and the financial regulations;
- in accordance with the budget and that funds are available; and that,
- appropriate approval processes exist;
- effectively and efficiently; and that, the financial reporting of activity is reliable.

Control also is designed to ensure that actions are consistent with the ethical behaviour expected of civil servants.

4.2 To satisfy this control process management have a duty to ensure that:

- areas of responsibility are clearly defined;
- the organisational structure is appropriate to the requirements of the service or activity (and that means that the structure of the organisation is changed as needs change);
- personnel have and maintain a level of integrity and competence to perform their duties;
- any instructions are written and formal rather than unwritten and informal;
- there are clear and appropriate lines of reporting;
- appropriate disciplinary arrangements exist and are implemented.

4.3 The 'internal control' process is therefore by definition 'ex ante'. The element of the control process that relates to the verification and certification of transactions should cover all transactions (i.e. it is transaction based) and should require that all appropriate approvals are obtained before any payments are made (and/or orders placed or commitments made).

4.4 Approval of transactions is only one element of the 'control' process and that element cannot be deemed to be effective unless all the other elements of the control process exist. Therefore to focus 'control' on ensuring that transactions are properly approved is to fail to recognise that transaction approval is one of the last elements in a whole process of control, not the principal substance of the control process.

5 **What is 'internal audit'?**

5.1 Internal audit is the process by which line management satisfies itself that:

- the 'control' processes are appropriate and working properly (effective);
- the objective of value for money is being achieved;
- the management information and control systems are not corrupted and operate efficiently.

Internal audit is not responsible for implementing specific internal control procedures, that is the responsibility of the management.

- 5.2 The internal auditor's role is to assess the operational effectiveness of the control processes and to ensure that they are appropriate to the objectives of the organisation. To avoid being compromised the internal auditor should remain independent from the day-to-day administration of the organisation and therefore should report directly to the senior management of the organisation.
- 5.3 Internal audit, because it is designed to review operational effectiveness, should be systems based rather than transaction based. It should use sampling techniques to assess the quality of the control procedures and would be directed by the application of risk management techniques, i.e. it would focus its resources on the areas of greatest risk to the organisation.
- 5.4 An important starting point is risk. Internal audit should review all the internal control processes which mitigate all the most significant risks the organisation faces. These will include reputational (e.g. bad press) and financial risks.
- 5.5 A key issue for internal audit to address is that of 'materiality', that is, is the issue of significance to the organisation? There is no standard quantitative definition of materiality but it is incumbent on the auditor to understand the concept of materiality and its application to the organisation to which the audit applies. The United Kingdom statement of auditing standards (SAS 220) addressed to external auditors defined materiality in the following way:

'Auditors should consider materiality and its relationship with audit risk when conducting an audit:

'Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole –(and also for the public sector an event can be material if it is newsworthy). A matter is material if its omission would reasonably influence the decisions of an addressee of the auditors' report; likewise a misstatement is material if it would have a similar influence. Materiality may also be considered in the context of any individual primary statement within the financial statements or of individual items included in them. Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects.'

- 5.6 The United Kingdom Treasury has defined internal audit as 'an independent and objective appraisal service within an organisation. 'Internal audit primarily provides an independent and objective opinion to the Accounting

Officer (in the United Kingdom usually the most senior civil servant in a Ministry) on risk management, control and governance, by measuring and evaluating their effectiveness in achieving the organisation's agreed objectives. In addition, internal audit's findings and recommendations are beneficial to line management in the audited areas. Risk management, control and governance comprise the policies, procedures and operations established to ensure the achievement of objectives, the appropriate assessment of risk, the reliability of internal and external reporting and accountability processes, compliance with applicable laws and regulations, and compliance with the behavioural and ethical standards set for the organisation.

'Internal audit also provides an independent and objective consultancy service specifically to help line management improve the organisation's risk management, control and governance. The service applies the professional skills of internal audit through a systematic and disciplined evaluation of the policies, procedures and operations that management put in place to ensure the achievement of the organisation's objectives, and through recommendations for improvement. Such consultancy work contributes to the opinion which internal audit provides on risk management, control and governance.'

6. **The overlap between 'control' and 'internal audit'**

- 6.1 The point at which there is a potential for overlap between 'control' and 'internal audit' is where 'control' activity includes an ex post review of transactions. Could and should this overlap be avoided? Ex post review is essential but should be carried out by external audit. Modern internal audit is focussed on systems and it will test systems (using risk assessment techniques) by inter alia using transaction information. This should not be confused with 'control' where the focus is by definition on the transaction rather than the systems.
- 6.2 A line ministry that maintains an ex post control system, even where based on sample transactions risks the following:
- duplication of activity with internal audit (where that exists);
 - ignoring the need for systems review including the operational effectiveness including appropriateness of those systems;
 - focussing on legality and conformity with the law and the budget at the expense of value for money review;
 - regarding ex post control as a substitute for ex ante control when it is definitely not; ex post control should be in addition to ex ante control.
- 6.3 What is needed is clear roles, responsibilities and the minimum of unnecessary duplication of effort for:
- internal control processes
 - internal audit

- external audit.

7 Does the Ministry of Finance require a control and an internal audit function?

7.1 Control is a function of line management and to the extent that a Ministry of Finance has line management responsibilities (and all will to a greater or lesser degree) then it should have a control function to deal with its own line management responsibilities. However, that control function should not extend to the control of line departments. In addition a Ministry of Finance may also have a range of other functions connected with the financial management of the activities of the government. These may include responsibility for a central accounting system, a centralised payments systems, cash management systems, debt management systems , payroll, debtor/creditor control and bank reconciliation.

7.2 Internal audit is also a function of line management and the Ministry of Finance will need its own internal audit function to serve its own internal management purposes:

- To ensure that the control procedures within the Ministry are appropriate and operate effectively;
- to satisfy itself that the central financial systems are relevant to their purpose and that they operate efficiently and effectively;
- the central accounting systems are robust and facilitate the preparation of the financial accounts of the government.

7.3 The internal audit activity of the Ministry of Finance designed to review the management arrangements within the Ministry of Finance should not have wider responsibilities extending to the internal audit of all Ministries.

8 The organisational responsibilities of the Ministry of Finance towards control and internal audit.

8.1 Because control is the responsibility of line ministry management (including the Ministry of Finance), that management should have full responsibility for all ex ante control. Ex ante control should not therefore be centralised in the Ministry of Finance because to do so distracts from the responsibilities, which should properly lie with line management.

8.2 However the Ministry of Finance should specify the standards to ensure that line ministries introduce appropriate control arrangements.

8.3 Similarly, internal audit should be a function of line management (with the proviso made above about the needs of the Ministry of Finance for its own internal audit function).

8.4 As with control, the Ministry of Finance should specify the internal audit standards to be adopted by line ministries.

8.5 However, the following issues do need to be addressed in considering the organisation of internal audit:

- skills training will be required and that should be common and should extend to professional training);
- because internal audit in particular is a specialist skill and (although important not central to line management policy activity) there is a risk that specialist skills training may not be given the priority needed unless there is a central management instruction;
- some line management needs for internal audit may be too limited to require a full internal audit department;
- some specialist internal audit skills are in scarce supply, such as computer and contract audit skills.

8.6 Given these circumstances, there is an argument for a central internal audit function based in the Ministry of Finance (but not a central control function). Such an arrangement is not without risk because internal audit should report directly to senior ministry management. There is a risk that a 'lack of trust' may develop between the central internal audit service and line ministry management. A centralised internal audit could be seen as the creature of the Ministry of Finance rather than providing a service to line management. Care will therefore be needed to minimise this risk and all reports should be available directly to line management whose responsibility is to respond directly to these reports – whether by acceptance (full or partial) or rejection.

8.7 Various arrangements are possible and they include:

- The centralisation of scarce internal audit resources only such as computer and contract audit skills;
- Provision of a central service for only those Ministries that are not sufficiently large to justify provision of a separate internal audit service;
- Appointing an official in the Ministry of Finance to be the professional head of the internal audit service and responsible for the professional development and training of all internal audit staff but not having operational responsibility;
- Making the internal audit service independent of any one Ministry and establishing it as a resource available to all Ministries with all Ministries providing representatives for a supervisory board.

There are advantages and disadvantages to each of these alternatives.

9 Internal audit and external audit

9.1 Internal and external audit should liaise and external audit should be able to rely on the work of the internal auditor (testing the quality of that work as appropriate). External audit should provide comment to line management and central management where appropriate) about the:

- standards
- quality and
- coverage of internal audit.

9.2 External audit should not duplicate the work of internal audit unless it has particular grounds for concern.

9.3 The external auditor should be expected to periodically examine and suggest improvements to both the control and internal audit arrangements that exist within the individual line ministries and the Ministry of Finance.

10 A checklist for Managers

10.1 The International Organisation of Supreme Audit Institutions (INTOSAI) has prepared a checklist for managers on control and internal audit. This is attached for reference purposes as an annex to this paper.

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References:

Internal Control: Providing a Foundation for Accountability in Government
(INTOSAI)
H.M. Treasury Internal Audit Manual
U.K. Statement of Auditing Standard 220

Annex

Checklist for Managers

In establishing your framework, have you

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

For implementing internal control, have you

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

Concerning the audit function, have you

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