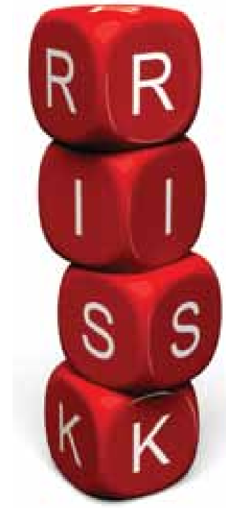

Strengthening Control and Integrity: A Checklist for Government Managers

By James A. Bailey

The next contribution is based on a Center report by Professor James Bailey, Strengthening Control and Integrity: A Checklist for Government Managers. It follows Hardy's piece on enterprise risk management and focuses on managing risks to strengthen the financial control and integrity process that may lead to better decision making. Taken together these two articles provide state-of-the art overviews on how governments at all levels can improve their control and risk management activities, which in turn, can lead to better decision making.

The Challenge of Risk Management

Governmental organizations manage risk on a daily basis. Unfortunately, many governmental organizations manage risk in a haphazard, unsystematic way. While organizations may address a few risks, they do not systematically manage other important threats and opportunities. This unsystematic approach limits the ability of organizations to achieve important outcomes.

In many organizations, government management does not avail itself of the benefits of a systematic approach to managing risks. Some managers may not understand how to implement risk management activities. Others may not believe that risk management activities can benefit their organization. Still others delay implementing such activities.

This article is aimed at government managers as they address the problems most governmental organizations face. It presents an overall framework for managing risks; specifically, financial controls and integrity. It shows how to systematically implement financial-control and integrity activities. These management processes benefit governmental organizations by helping them identify, prioritize, and focus their resources to produce high-impact opportunities and reduce high-impact threats. It will focus on the two key aspects of risk management: assuring financial controls and integrity.

Effective Risk Management Activities for Assuring Financial Control and Integrity

Effective risk management processes possess the following three elements:

- **Define the Problem.** Identify opportunity and threat outcomes, prioritize high-impact opportunity and threat outcomes, and focus the organization's efforts to produce high-impact results.
- **Manage Internal Risk.** Direct the organization's resources to produce high-impact results.
- **Evaluate and Oversee Internal Risks.** Protect the organization's resources from misuse.

Using Risk Management Processes to Manage High-Impact Outcomes

High-impact outcomes include positive or negative events that might show up on the front page of the newspaper. These outcomes may include negative events such as violence against employees or theft of the organization's resources. One generally thinks of negative outcome events when considering risk management. However, risk management also deals with positive outcome events such as excellent organizational performance. Risk management programs focus the governmental entity's efforts and resources on maximizing positive and minimizing negative high-impact outcomes.

Risk management benefits organizations by helping them maximize their high-impact opportunity outcomes and minimize high-impact threat outcomes. By implementing a risk management process, the government entity increases the likelihood that it will achieve positive high-impact opportunity outcomes and minimize negative high-impact threat outcomes.

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Strategies for Managing for High-Impact Outcomes

The risk management process cycle for financial controls and integrity is divided into three phases. Implementation of risk management activities increases the likelihood of maximizing high-impact opportunity outcomes and minimizing high-impact threat outcomes. The three phases are:

- **Phase One: Government managers identify opportunity and threat outcomes.** They prioritize the high-impact outcomes over the low-impact outcomes. The managers focus the organization's attention on the high-impact outcomes.
- **Phase Two: Organizations manage resources and processes to achieve the high-impact opportunity outcomes and minimize high-impact threat outcomes.**
- **Phase Three: Government managers evaluate the high-impact outcomes.** When management completes the evaluation, the process begins again.

I explain how to systematically go through this process. The next section describes Phase One, how government managers identify high-impact outcomes using a strengths, weaknesses, opportunities, and threats (SWOT) analysis; how they prioritize outcomes using impact and likelihood analysis; and how they incorporate high-impact outcomes into mission statements and objectives to focus attention on achieving these outcomes. The next section discusses Phase Two and how organizations manage resources and processes to achieve positive high-impact outcomes while reducing negative high-impact outcomes, especially in the area of governmental finances and financial processes. The last section discusses how to evaluate outcome achievement in Phase Three. Figure 1 shows the tools used in each phase.

This article highlights some best practices and provides financial oversight and integrity checklists that managers can use to assess their organizations.

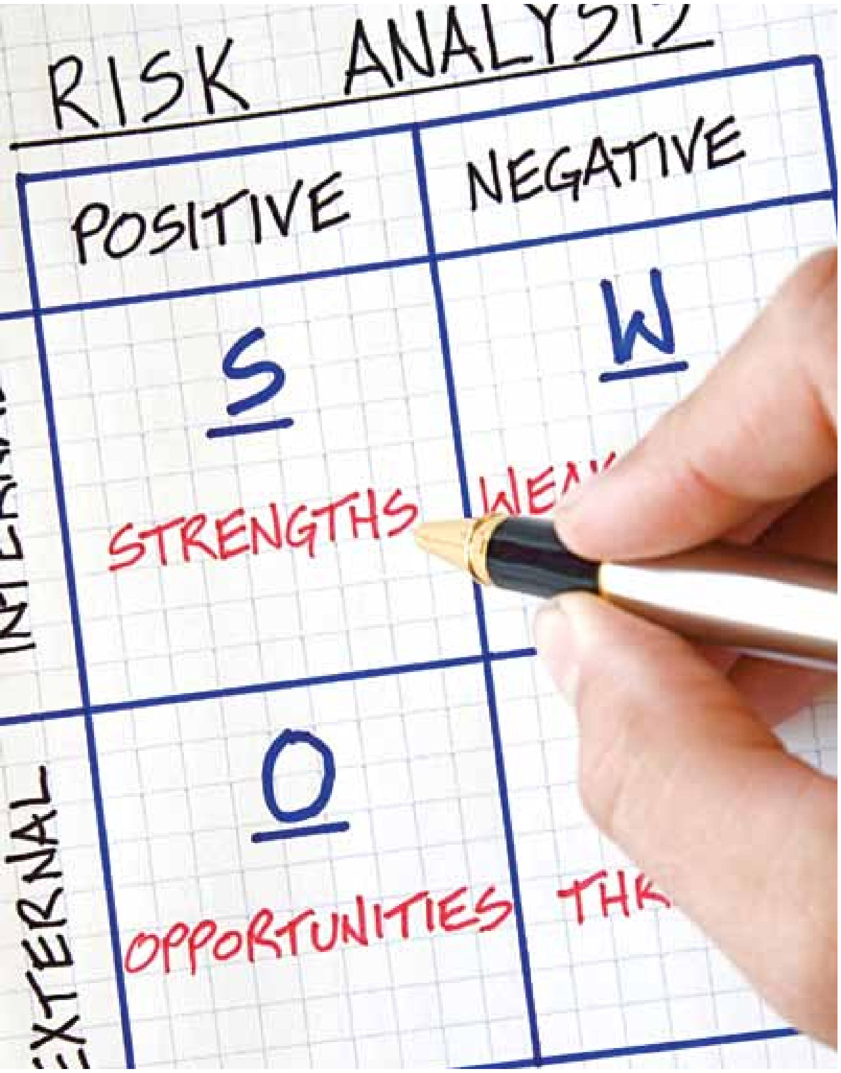
Phase One: Define the Problem

Identify

Governmental entities manage their strengths, weaknesses, opportunities, and threats on a daily basis. Unfortunately, many managers do not systematically identify their opportunities and threats or their greatest strengths and weaknesses. By not using a systematic process, a government entity may fail to identify important strengths, weaknesses, opportunities, or threats. By failing to identify these areas, the organization cannot effectively manage them.

Figure 1: Processes and Tools for Managing Risks to Assure Financial Control and Integrity

PHASE	PROCESS	TOOL
ONE	**Define the Problem** – Identify – Prioritize – Focus	– SWOT Analysis – Impact and Likelihood Analysis – Mission and Objective Analysis
TWO	**Manage Internal Risk**	Risk Management and Control Analysis
THREE	**Evaluate and Oversee Internal Risks**	Outcome Assessment Analysis



SWOT Analysis

SWOT is an acronym for "strengths, weaknesses, opportunities, and threats." Organizations can identify high-performing internal processes and significant external influences by using a SWOT analysis. A SWOT analysis helps systematically identify and list the key strengths, weaknesses, opportunities, and threats facing the organization.

Outcome Identification

After identifying strengths, weaknesses, opportunities, and threats, the organization then uses the list to develop an outcome identification table. The table identifies potential outcomes based on how the entity's strengths and weaknesses interact with its opportunities and threats.

Prioritize

Some organizations do SWOT analyses to identify their strengths, weaknesses, opportunities, and threats. Many administrators and governmental boards do not systematically prioritize these areas. By not using a systematic process, an organization may fail to effectively prioritize opportunity or threat outcomes. If the organization fails to prioritize these areas, it cannot effectively manage its high-impact outcomes.

Likelihood Analysis

After listing outcome events and assessing their impacts, the next step is to assess the likelihood of the outcome occurring. Management controls through policies or processes influence the likelihood of the event occurring. Effective controls increase the likelihood of achieving opportunity outcomes and preventing threat outcomes. Non-control-related factors also may contribute to the likelihood of achieving the outcomes.

Phase Two: Manage Internal Risk

Management's risk philosophy and risk appetite will impact the organization's response to risk. According to the Enterprise Risk Management—Integrated Framework, a risk management philosophy includes the shared values, beliefs, and attitudes of the organization that influence its culture, operating style, and risk management processes. Policies, communications, and actions emphasize and reinforce the organization's risk management philosophy. The risk management philosophy influences risk appetite, which is the amount of broad-level risk acceptable to achieve opportunities or minimize threats. Organizations should consider their risk philosophies and appetites as they consider the framework's four strategies for responding to risks:

- **Acceptance.** Organizations may choose to accept risk. When accepting risks, the organization chooses to do nothing with the risk. It may decide that the cost of managing the risk exceeds the benefits. The organization may choose to accept risks for low-impact opportunities or threats. Accepted risks require no further management action.
- **Avoidance/Eliminate.** Organizations may decide to avoid the risk by eliminating the activity. It may eliminate the activity associated with the risk because the costs of the activity exceed the benefits. The organization may choose to eliminate activities associated with low-impact opportunities that have a low likelihood of occurring. It also may want to eliminate activities that lead to high-impact threats with a high likelihood of occurrence. Eliminated risks require no further management action.
- **Sharing/Transfer.** Organizations may choose to share risk by transferring it. The organization may decide to transfer risk by outsourcing activities that result in low-impact opportunities. It also can transfer risk by acquiring insurance for high-impact threats. The organization should consult with experts in outsourcing or insurance to evaluate the cost and benefits of using these approaches for selected activities.

- **Reduction/Control.** Organizations may choose to reduce the risk of achieving high-impact opportunities or avoiding high-impact threats. It may implement control activities designed to maximize high-impact opportunities or to minimize high-impact threats.

Financial Controls: Reporting, Internal Control, and Compliance

The Committee of Sponsoring Organizations of the Treadway Commission issued its Internal Control–Integrated Framework in 1992. According to the framework, effective internal controls provide a reasonable assurance of an organization's compliance with regulations and laws, the reliability of its financial statements, and the achievement of its organizational objectives. Organizations can apply risk management and internal controls to any objectives within their organization.

Effective internal controls provide a strong foundation for audits of public organizations. Under the Single Audit Act, which is applicable to many local governmental audits, the external auditor evaluates and provides reports on the organization's financial statements, internal controls, and compliance with laws and regulations. Strong internal controls reduce the risk of problems in all three of these areas.

Management, the board, and the audit committee, where applicable, should provide proper oversight of financial reporting, internal control, and compliance issues. Prior to the release of the audited financial report, the board and its audit committee should review and discuss the reports discussed in this section with management, the internal auditor, and the independent auditor.

The author presents a financial reporting, internal control, and compliance checklist. Management, the board, and the audit committee should use this checklist to assess their financial reporting, internal control, and compliance processes. Management and the board should require corrective action where deficiencies exist.

Integrity: Management and Board Oversight

The control environment forms the foundation of a strong internal control program. Effective management and boards are critical components of the control environment. Major responsibilities of both managers and local government board members include exercising the duties of loyalty and care. Local governments often have a variety of governing entities, such as city councils, school boards, park boards, and other oversight boards.

Exhibit 1: Financial Reporting, Internal Control, and Compliance Checklist

Organization Name: ______________________________

Completed by: ______________________________ Date: ______________

	Financial Reporting, Internal Control, and Compliance Matters	Yes	No
1.	Prior to the release of the audited financial report, the board or audit committee reviewed and discussed with management, the internal auditor, and the independent auditor the following financial reporting matters:		
a.	Draft of annual audited financial statements, including related disclosures		
b.	Draft of independent auditor report		
c.	Significant financial reporting issues and judgments followed by the organization		
d.	Alternative financial reporting principles and practices that could have been followed		
e.	The financial impact of selected principles and practices versus alternatives		
f.	Significant changes in accounting principle(s)		
g.	Significant accounting estimates		
h.	Any disagreements between management and the auditors about financial reporting		
i.	Any difficulties encountered during the audit, including restrictions on access to requested information or on the scope of the audit		
j.	Auditor procedures and results related to AICPA's Statement of Auditing Standards No. 99—Consideration of Fraud in a Financial Statement Audit		
2.	Prior to the release of the audited financial report, the board or audit committee reviewed and discussed with management, the internal auditor, and the independent auditor the following risk and internal control matters:		
a.	Any risk assessment of the organization's fiscal operations developed under governmental auditing standards for a financial statement audit and federal single audit standards, if applicable		
b.	Management's internal control report on the effectiveness of the organization's internal control structure for financial reporting		
c.	Auditor's draft of the internal control report		
d.	Adequacy and effectiveness of internal controls, including computerized information system controls and security		
e.	Draft management letter provided by the independent auditor as well as other internal control findings and recommendations by auditors, and the administration's response		
f.	Small organization internal control considerations: • Entity-level controls • Management override risk • Segregation of duties—Alternative controls • Software application controls • Financial reporting competencies • Documentation		
3.	Prior to the release of the audited financial report, the board or audit committee reviewed and discussed with management, the internal auditor, and the independent auditor the following compliance matters:		
a.	Compliance with applicable laws and regulations		
b.	Material reports, inquiries, or correspondence from governmental or regulatory agencies that raise material financial reporting issues		
c.	Employee complaints or published reports that raise material financial reporting issues		
d.	Compliance with the organization's codes of conduct for employees, senior financial officers, and contractors		
4.	Prior to the release of the audited financial report, discussed with the independent auditor matters required to be discussed by AICPA's Statement of Auditing Standards No. 114—The Auditor's Communication With Those Charged With Governance		
5.	Prior to the release of the audited financial report, the board discussed with management and the organization's legal counsel the following:		
a.	Status of significant legal and regulatory matters that could have a material impact on the organization's financial statements		
b.	Related organization compliance policies and practices		
c.	Reports received from regulators		
6.	The board reviewed and discussed with management, the internal auditor, and the independent auditor the coordination of audits among internal auditor, independent auditor, and controller to achieve the following audit objectives:		
a.	Completeness of coverage		
b.	Reduction of redundant efforts		
c.	Effective use of audit resources		

Source: *Please refer to the report for a sample of this checklist.*

The author presents a management and board oversight checklist that includes many of the key concepts contained in this section. Managers and boards should use this tool to evaluate themselves, and they should require corrective action where deficiencies exist.

Exhibit 2: Management and Board Oversight Checklist

Organization Name: ____________________

Completed by: ____________________ Date: __________

	Duty of Loyalty	Yes	No
1.	Managers and board members ethically lead the organization by example.		
2.	Managers and board members ethically lead the organization through effective policies.		
3.	Managers and board members ethically lead the organization through effective communications.		
4.	Managers and board members always put the organization's interests ahead of their own personal interests.		
5.	Managers and board members ethically lead the organization through the avoidance of conflicts of interest.		
6.	Managers and board members ethically lead the organization by not participating in matters in which they have a personal interest.		
7.	Managers and board members always act in good faith in the interests of the organization.		
8.	Board members always maintain independence from management.		
	Duty of Care		
1.	Managers and board members acquire information about the organization through a reliance on others and through inquiry.		
2.	Managers and board members adequately prepare for meetings.		
3.	Managers and board members attend almost all meetings.		
4.	Managers and board members exercise reasonable care while fulfilling their duties.		
5.	Managers and board members adhere to the reasonable person standard.		
6.	Management board members are adequately trained to meet their responsibilities.		
	Administrator Oversight		
1.	The board appoints, replaces, and sets the compensation for the chief operating officer.		
2.	The board establishes policies to direct the chief operating officer's actions.		
3.	The board reviews the chief operating officer's performance.		
4.	The board approves all major financing and investing activities of the organization.		
5.	The board provides effective oversight of the administrative function.		
6.	The board does not perform management functions.		

Source: *Please refer to the report for a sample of this checklist.*

Phase Three: Evaluate and Oversee Internal Risk

Management and the local government board members evaluate the effectiveness of the risk management program. They can rely on the following three important groups to help them evaluate the organization's accounting and auditing outcomes and processes:

- The independent auditor
- The internal auditor
- The audit committee

Independent Auditor

The independent auditor assists management and the board by performing audits and reporting on the fair presentation of the annual financial statements. The independent auditor also assists management and the board with their fiduciary duty by reporting on the effectiveness of internal controls and the organization's compliance with laws and regulations.

Exhibit 3 presents an independent auditor checklist. The board or audit committee should use this checklist to assess the independence and performance of the independent auditor. Management and the board should require corrective action where deficiencies exist.

Exhibit 3: Independent Auditor Checklist

Organization Name: ____________________

Completed by: ____________________ Date: __________

The board and audit committee:

	Qualifications of and Relationships with Independent Auditor	Yes	No
1.	Reviewed external audit policies and regulations.		
2.	Reviewed the appointment, dismissal, and compensation of the external auditor.		
3.	Reviewed and discussed independent auditor's written statement describing all relationships between the auditor and the organization, and discussed with independent auditor any relationships or services that may impair the independence or objectivity of the auditor.		
4.	Reviewed and discussed the report of the independent auditor's internal quality control procedures, material issues raised by peer or quality review or governmental or professional authorities during the preceding five years, and steps taken to deal with the quality issues.		
5.	Reviewed the rotation of audit partners so that neither the lead nor the reviewing audit partner performs audit services for the organization for more than five consecutive years.		
6.	Reviewed and discussed the qualifications and experience of the senior members of the independent auditor's team.		
7.	Reviewed policies for the hiring of present or former employees of the independent auditor during the preceding five years.		
	Independent Audit Planning		
1.	Reviewed and discussed the scope of all auditing and non-auditing services provided by the independent auditor prior to the performance of the work.		
2.	Discussed auditor's plan to address AICPA's Statement on Auditing Standards No. 99—Consideration of Fraud in a Financial Statement Audit.		
	Discussions with Independent Auditors		
1.	The board or board chair held discussions in separate meetings with the independent auditor, management, and the internal auditor.		
2.	Discussed with the independent auditor the items on the Financial Reporting, Internal Control, and Compliance Checklist (Exhibit 1, page 14).		
3.	The board discussed with the independent auditor any disagreements with management, consultation with other independent accountants, difficulties encountered in performing the audit, major issues discussed with management prior to retention, significant deficiencies in internal control, fraud, and illegal activity.		
4.	Reviewed the management representation letter.		
5.	Reviewed the performance of external auditor, including the lead audit partner.		

Source: *Please refer to the report for a sample of this checklist.*

Internal Auditor

Internal auditors assist management and the board in monitoring internal control processes. The internal auditors primarily focus on assessing the effectiveness of internal controls and monitoring the organization's compliance with laws and regulations. Internal auditors generally do much more detailed analyses in these areas, uncovering more fraud than the independent auditors. They also perform audits to assess the efficiency and effectiveness of the organization's programs.

The author presents an internal audit checklist. Management, the board, and the audit committee should use this checklist to assess the objectivity and performance of the independent auditor. Management and the board should require corrective action where deficiencies exist.

Exhibit 4: Checklist for Oversight of Internal Audit

Organization Name: ____________________
Completed by: ____________________ Date: __________

The board and audit committee:

		Yes	No
1.	The board or board chair held discussions in separate meetings with the internal auditor, management, and the independent auditor.		
2.	Reviewed any difficulties encountered by the internal audit and any limitations on the audit scope or access to information.		
3.	Reviewed the internal audit charter.		
4.	Discussed internal audit's compliance with the Institute of Internal Auditors' Standards for the Professional Practice of Internal Auditing.		
5.	Evaluated the internal audit's performance.		
6.	Reviewed and made recommendations for the internal audit's annual audit plan and significant changes to the plan.		
7.	Reviewed the internal audit's budget, staffing, and qualifications.		
8.	Reviewed the internal audit's summary of audits completed and the administration's response.		
9.	Reviewed the appointment, compensation, and change of the senior internal auditor.		

Source: *Please refer to the report for a sample of this checklist.*

Management Oversight

Management, the board, and the audit committee should review and recommend improvements to the governance, risk, or financial internal controls policies and practices. They should evaluate the control environment as defined by COSO's Internal Control–Integrated Framework.

The author presents a checklist for assessing management oversight. Management, the board, and the audit committee should use this checklist to assess the objectivity and financial performance of management. Management and the board should require corrective action where deficiencies exist.

Audit Committee

Management and boards may form audit committees to monitor the organization's financial reporting, internal control, internal audit, and external audit processes and to advise management and the board on auditing, internal control, and financial reporting issues.

Exhibit 5: Checklist for Oversight of Management

Organization Name: ____________________
Completed by: ____________________ Date: __________

The board and audit committee:

		Yes	No
1.	The board or board chair held discussions in separate meetings with the management, the independent auditor, and the internal auditor.		
2.	Reviewed the qualifications of the chief financial officer, the controller, and the accounting staff.		
3.	Reviewed governance and financial internal control policies and procedures and the cost/benefit of these policies and procedures. Reviewed financial governance monitoring reports.		
4.	Reviewed the performance of management's financial functions.		
5.	Reviewed the control environment.		
6.	Reviewed policies and practices relating to the codes of conduct.		
7.	Reviewed policies and practices relating to the compliance and ethics program.		
8.	Reviewed and recommended policies and practices for the receipt, retention, and treatment of complaints received by the organization regarding accounting, internal controls, or auditing matters.		
9.	Reviewed and recommended policies and practices for the confidential, anonymous submissions by employees of concerns with regard to auditing, accounting, or internal control matters.		
10.	Reviewed significant complaints regarding accounting, internal controls, or auditing matters.		

Source: *Please refer to the report for a sample of this checklist.*

Management and the board should establish an audit committee to assist them with their oversight duties. The full report provides an example of a charter for an audit committee. Management and the board should require corrective action where deficiencies exist.

TO LEARN MORE

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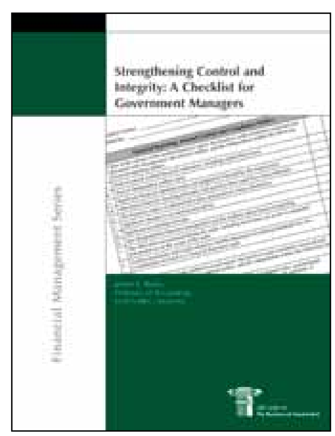

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