
Internal Control for Operational Effectiveness*Vinod Sahgal***1. Introduction**

I must commend the Controller General of Accounts (CGA), Ms. Aruna Makhan for inviting professional colleagues from our region to participate in this seminar. It is a wonderful opportunity for all of us to get to know each other, get a better sense of contemporary issues, and try to formulate a plan for addressing these issues on a regional basis. Our experience has been that there is much in common – a culture that is very rich and diverse, yet much is needed for strengthening our systems of financial management, control and accountability. I believe we are sitting on a golden opportunity. This paper is written to share our views with the Region based on initial experience in India and from North America.

The World Bank pays special attention to internal control. The Bank's Charter (Article 111 Section V (b) of IDA's Articles of Agreement) specifies that: "The bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency and without regard to political or other non-economic influences or considerations." There is an expectation that diversion of funds will be minimized and used for the purposes intended. In addition that they are used "wisely". The emphasis is on the word "used" not only spend and then there is the question of economy and efficiency i.e. productivity or results that count.

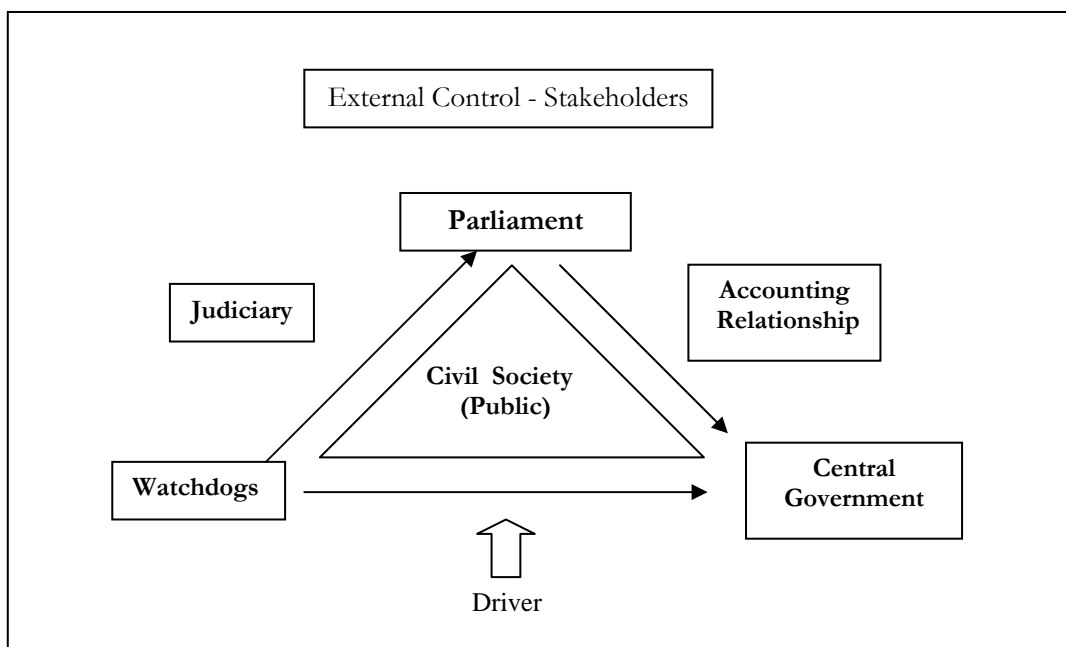
We have top-notch professionals across South Asia. We can all contribute to the accounting and internal control information needs for good governance in the region. We can also offer our services to other developing countries wishing to address similar issues – whether in East Asia or Africa or Europe or elsewhere.

2. Internal Vs External Control – the Governance Perspective

A proper understanding of the subject – "Internal control for Operational Effectiveness" requires that we keep in mind an appreciation not only of the importance of control as a tool for administering government activities and managing performance but also draw a distinction between the role of internal control from external control. As some of you may be aware, the World Bank is a pioneer in the conduct of Financial Accountability Assessments that cover both these aspects.

External Control is at the heart of democratic governance. The prevailing system of accountability of the Executive to the Legislature and of Legislature to the public is governed by

a series of institutions and stakeholders – the Estimates and Public Account Committee, the media, civil society and other watchdogs such as the public audit function come to mind. The Comptroller and Auditor General of India (CAG) and the Public Accounts Committee (PAC) play a key role in this arena.



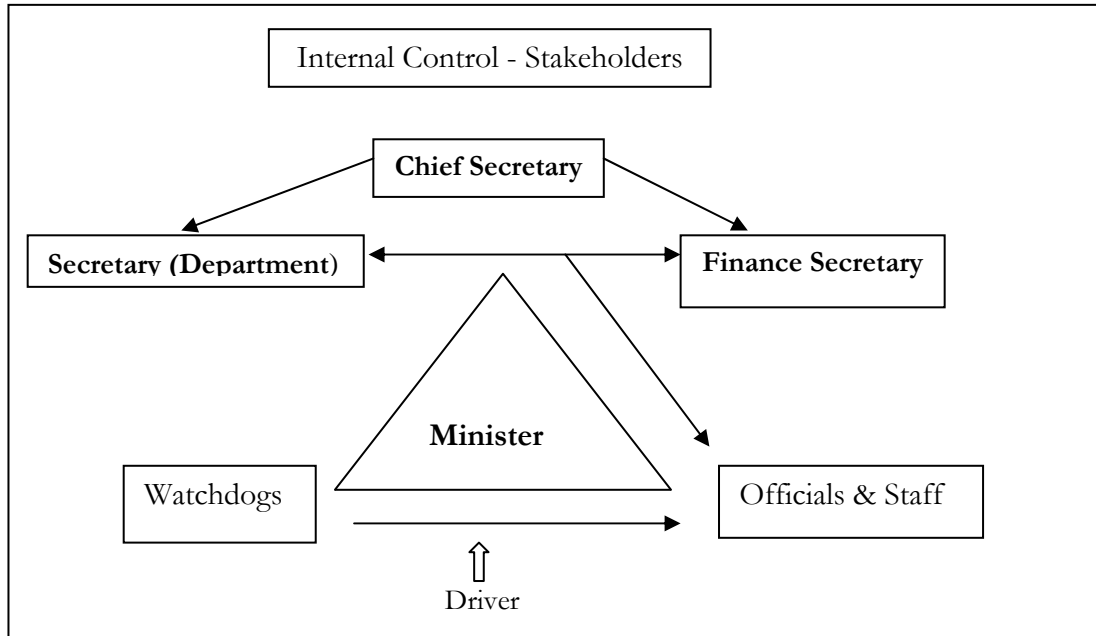
Internal control, on the other hand, is about public sector management. The effectiveness of this institution is linked with the ability of the Executive to respond to the external environment – the “demand” side of public financial accountability. The Ministry of Finance and the CGA are at the heart of this institution. As are the Chief Accounting Officers of line Departments.

An internal control plan is defined as, “a high level summarization, on a department-wide basis, of the department’s risk (as the result of a risk assessment) and of the controls used by the department to mitigate those risks. This high level summary must be supported by lower level detail, i.e., departmental policies and procedures”¹.

Internal control is ultimately about the role and responsibilities of the Secretary² of the Government in his/her capacity as Chief Accounting Officer, to deliver programs and activities using public resources. The “System” of managing resources with due regard for economy and efficiency and to ensure that public funds are used for the intended purposes is the foundation for “internal control”. In World Bank parlance we refer to this function as the management of the fiduciary risk.

¹ The office of the Comptroller, Commonwealth of Massachusetts (State), USA

² Research paper on “Accountability of Secretary to Government of India” prepared by Consortium for Financial Management of Public Systems, New Delhi, India



3. Institutional Framework

The framework for internal control is very well laid down in India. The Rules of Procedure of Parliament have provisions for holding the Chief Accounting Officer (the Secretary of the Government) answerable for the efficient use of funds and for the propriety of the transactions incurred by the Executive. More recently the expectation has broadened to include financial reporting on departmental results. But this is not explicitly stated in the General Financial Rules³ in India. This is the first step towards the need for accounting for results.

The *General Financial Rules* (GFRs) amplify on the procedure for internal control. They stress the importance of checks and balances (for example – monthly bank reconciliations, evidence to support all financial transactions, segregation of duties, etc.) over cash transactions. More recently, the realization that accrued liabilities, contingent liabilities and Letters of Comfort also do need to be watched carefully has emerged. Concurrently, there is increasing realization among professionals that asset management procedures need to be tightened. The viability of development projects is under great scrutiny. Managing the cost and time involved in project delivery has control implications.

There is also Article 310 and 311 of the Constitution that restricts politicization of the bureaucracy. These are some of the many examples of the components of the Institutional Framework that governs internal control in the context of public administration.

In India, the CAG is seen as the champion of internal and external control. In the international field – the CGA’s accounting function is crucial to success. The Bank has adopted the **Committee on Sponsoring Organization of the Treadway Commission** (‘COSO’) model as its standard for internal control.

³ For example, The Orissa General Financial Rules, Volume 1, Third Edition(Corrected up to 31st August 2000)

4. What is Internal Control?

“If men were angels, no government would be necessary”.

The basis for internal control was founded in the requirement for government to control the governed. This was a colonial concept. The “system” of public financial accountability we have developed in the nineteenth century in the U.K. and it is quite remarkable that the overall structure has withstood the test of time. It is continuing to be seen as a primary tool for effective administration.

The General Financial Rules of the government prescribe the rules, controls and requirements for compliance. The administration is hierarchical and authorities have been established on that basis. Segregation of duties is stressed. Formats for reporting are prescribed and so on.

In North America and elsewhere much thought has been given to this subject. Internal control is a management tool used to provide reasonable assurance that management objectives are being achieved, according to the Guidelines for Internal Control Standards, issued by **International Organization of Supreme Audit Institution (INTOSAI)**. As they are ultimately responsible for the adequacy of the internal control structure and its implementation, it is important that management of all organizations units within the Government understand the nature of the internal control structure and the objectives internal controls are to achieve. Internal control, or management control as it is increasingly called, helps to provide reasonable assurance that the organization

- ❖ adheres to laws, regulation, and management directives;
- ❖ 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 organizations mission; and
- ❖ develops and maintains reliable financial and management information; and
- ❖ fairly discloses that data through timely reporting.

The more modern approach to internal control has broadened the ambit of this institution. Today, the emphasis is moving towards management control with emphasis on government to be obliged to control itself. The focus is on service delivery. This change responds to the process of democratic governance and the role of public participation in decision making.

According to COSO, the three primary objectives of an internal control system are to ensure (1) efficient and effective operations (2) accurate financial reporting, and (3) compliance with laws and regulations. Internal controls consists of the following five interrelated components:

- ❖ **The control environment**, which establishes the foundation for the internal control system by providing fundamental discipline and structure.
- ❖ **Risk assessment**, which involves the identification and analysis by management – not the internal auditor – of relevant risks to achieving predetermined objectives.

- ❖ **Control activities**, or the policies, procedures, and practices that ensure management objectives are achieved and risk mitigation strategies are carried out.
- ❖ **Information and communication**, which support all other control components by communicating control responsibilities to employees and by providing information in a form and time frame that allows people to carry out their duties.
- ❖ **Monitoring**, which covers the external oversight of internal controls by management or other parties outside the process; or the application of independent methodologies, like customized procedure or standard checklists, by employees within a process.

Control, that is direction more so than regulations, has replaced the traditional emphasis on “controls” meaning detailed rules and procedures. An analogy that comes to mind is of a motor car. The emphasis today is on the driver and the steering wheel, more so than the brakes, clutch or the dashboard. Both aspects are of course essential. The need is for balance. Good “control” is about clarity of purpose, a commitment to organizational goals, ethical action, monitoring and learning lessons and so on. This cycle of accountability brings in the notion of true public service and the need to deliver and account for results.

Modern internal control encourages team work, clarity in vision and mission, as well as performance standards as benchmarks for operational effectiveness. Government departments are required to prepare Perspective Plans. This is a good starting point. The change in management information requirements for this new paradigm is towards the integration of financial and non-financial information. Managers want to know not only how much is spent against budget but also what was achieved against plan. Next, they want to know if the cost of providing service can be minimized.

Citizens want to have an assured supply of electricity **and** at the right cost. The kind of information required to meet this obligation encourages government to provide more meaningful information both to itself for managing its resources, as well as to the public on the cost of delivering public services – health, education, water or whatever.

In summary, the concept of internal control has broadened from a tool of administrative control to one of managerial performance. The emphasis on accounting and control is increasingly for operating results rather than solely for spending to budget. It is not only the cost of the Metro in Delhi that concerns the public but also the quality of service and cost per mile of construction.

5. Evolution taking place around the globe

The first point here is that the public is at center stage, not the government. The enactment of access to information laws⁴ around the world is opening up public decision-making process to

⁴ The most significant achievement on the legislative side has been the enactment of the Freedom of Information Act (FOI) by Government of India in January 2003 which is applicable to all States of India (except Jammu and Kashmir). The FOI Act, 2002 will be implemented in the States of India once rules and regulations related to the Act are formulated.

civil society and the media. The Central Government has recently enacted a law that has great promise. The rules of procedure for implementing the laws are awaited. Similar laws have been passed in Karnataka, Goa, Maharashtra, Rajasthan and others.

Given India's excellent strength in the field of information technology and the widespread use of the Internet among the growing number of civil society organizations, there is every hope that the system of public financial accountability with the more modern approach to internal control will flourish. The flow of financial information to the public is improving. The same for non-financial information. Accounting information formats are being made user friendly.

The public is becoming sensitized to the need for common accounting standards. Best Practice benchmarking is emerging and most commendable is the CGA's contribution to the provision of timely information of the monthly financial position of the Central Government. State Governments are following suit.

The demand for information too is gaining momentum. The UTI scam was a trigger to strengthening corporate internal control in the financial sector. We are seeing significant improvement in the supervision of banks, cooperatives and other public bodies. The focus is on:

- ❖ Tone at the top;
- ❖ Ethical practices;
- ❖ Risk management; and
- ❖ Useful financial and non-financial information

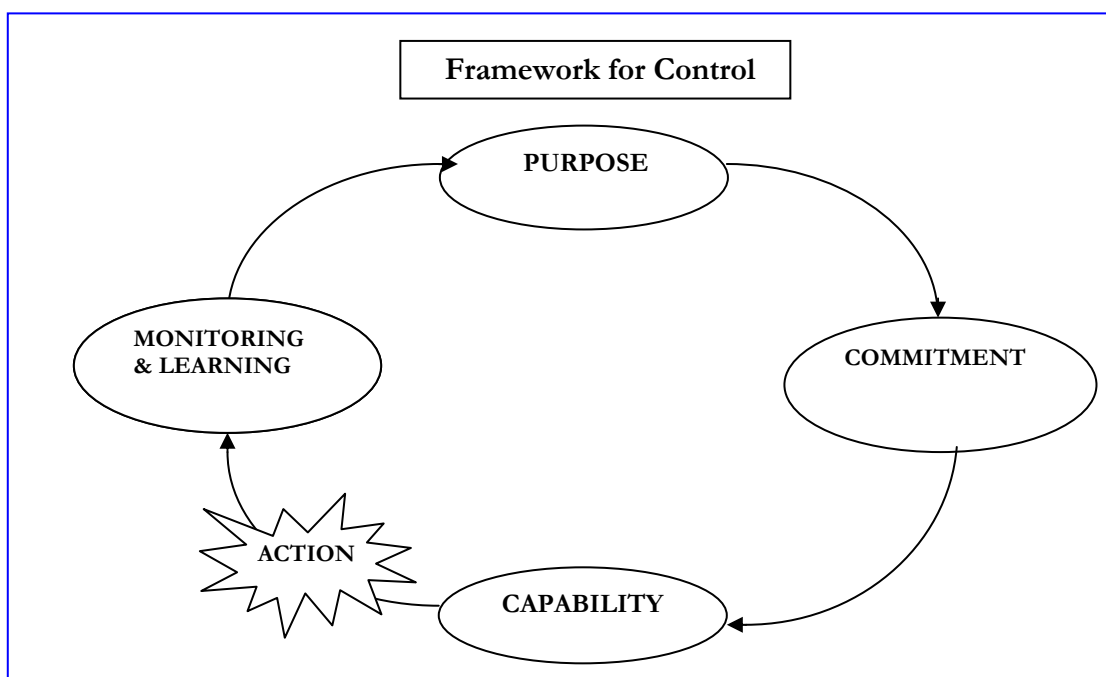
Accounting for results was chosen as the theme for this seminar. This is very appropriate for the environment we are in today. Managing for results – poverty reduction being one crucial objective is being emphasized by the Government of India as well as the international community. The evolution in both demand and supply of information is leading towards stronger governance and accountability.

In summary, internal control works best when the accounting infrastructure within the government provides useful information on both inputs (money, material, time, etc.) as well as outputs and outcomes (improved health, education, rural poverty and so on).

Accounting is becoming a management tool and a matter of public interest. Secretaries of the government are increasingly in the driver's seat. They need management accounts for decision making.

In summation, a new framework for control has emerged around the world – public and private sectors. This framework is driven by:

- ❖ clarity of purpose;
- ❖ commitment to organization objectives;
- ❖ capability of our system of human resources; and
- ❖ monitoring and learning capacity.



Source: Guidance on Control, November 1995. The Canadian Institute of Chartered Accountants

Note: The CCAF-FCVI provides a framework for control that is based on twelve attributes that cover all significant aspects of management control for organizational effectiveness. These can be accessed from the web site of the CCAF in Canada.

6. An outsider's perception of internal control in South Asia

There appear to be four distinct cultures prevailing in the Region. This is not very different from countries like Canada and others back in the seventies.

❖ Government Department

Controls and procedures dominate the scene with internal control equated with detailed rules procedures, from etc. The focus is on compliance and the expectation is accountability by fiat. We see "circulars" sent out as the means of internal control. The accounting system is almost exclusively focused on expenditure against budget. The incentives for performance are mostly negative. The control environment discourages risk taking. It is not at all clear whether enforcement actually works.

❖ Public Sector

This sector has the trapping of the private sector but the culture of the Government Sector. In many cases senior officials act as managing directors of Public Sector Undertakings. The operating style is a bit of both public and private sectors. Financial reporting dominates the context in which accounting system operate. There is little information captured on the extent to which public policy objectives are being met. Accounting for results has not fully emerged. Results that count are difficult to assess.

❖ Private Sector

The private sector has a clear bottom line. Results count. Financial reporting standards tend to meet Best Practice. In most progressive companies internal reporting includes the meeting of social objectives. The promotion of environmental accounting is emerging. Internal control is increasingly driven by results. Results could be financial and or non-financial.

❖ Non Government Organizations (N.G.Os)

This sector is a mixed bag. However, the public's knowledge of their internal control arrangement and culture is limited. There are likely significant variations across the country and Region and types of NGOs. Much depends upon the leadership of the NGO.

7. Overall Assessment

My overall assessment would be that the cup is more than half full. Computerization has paved the way for accounting reforms. While the Central Government in India, for instance, may have the ability for the more modern internal control so necessary for operational effectiveness, the States may need substantial technical and financial assistance.

The good news is that there is a growing desire to modernize, simply and de-bureaucratize the internal control system. Officials are looking for Best Practice within India and from overseas. Off-budget borrowing is becoming more visible, as in the case of Karnataka's Special Purpose Vehicles, controls over guarantees at Orissa or the need for improving response to audit observations at Andhra Pradesh. Internal Audit at the Central Government is looking for ways towards capacity building. Monitoring centrally sponsored schemes across India particularly in rural areas has become a priority.

There are also significant opportunities. For example, the Consortium on Financial Management of Public Systems points out that the accountability of the Secretary to the Government of India is unclear beyond accounting for "inputs"-- there is no specific requirement in regulations for reporting on results. I raise this point because the move from an "administrative" model of internal control to a "management" model suggests that the accountability for results be clarified at this important level. The corporate culture is looking attractive to the public sector.

Our experience suggests that a number of areas of internal control need attention. The area of budget realism comes to mind as does monitoring and evaluation, performance reporting and the capacity for learning lessons and acting swiftly on cases involving enforcement. Just last week the Economic Times had an article "A lax income-tax department gathers demand arrears" – pointing out that much of the malady is because of a lack of accountability and control on the part of the tax department's systems.

8. Main Conclusions and Recommendations

The main conclusion is that the system of internal control will need to be further modernized for Accounting for Results. Government productivity can be enhanced by the use of more broader thinking on internal control. The mindset is evolving towards corporatization. The traditional “administrative” model needs to be broadened even further towards a ‘management’ model that incorporates a mindset for economy and efficiency, in addition to spending within budget. Reliance on trust and integrity rather than extensive supervision based on detailed rules, regulations and procedures would be more cost effective.

Next, “A library full of the best rules in the world cannot provide assurance that the fiduciary risk is well managed unless those rules are implemented with the spirit behind the formulations”⁵. Perhaps we need **less** not more laws, regulations and perhaps a bit more management orientation in public institutions.

We can be optimistic in South Asia. This part of the world is well endorsed with skills, knowledge and education to take on the challenge for greater operational effectiveness. Widespread computerization has begun across the region. Public access to information will be a strong driver of demand for operational effectiveness. The role of the Secretary of the Government is being clarified through the effort of this profession. Consortium for Financial Management of Public Systems is commended for its contribution in this area. And capacity building for improving the management and accounting for results is quite rightly on the CGA’s Agenda. We, from the World Bank are pleased to offer support to your process for facilitating such reforms. And we appreciate your efforts on regional exchange on this important topic.

⁵ Para 2of Chapter XI –Fiduciary Risk of the Government of Orissa State Financial AccountabilityAssessment(SFAA)

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