INTERNAL CONTROL TESTING
A Jargon-Free[1] Guide

"Internal Control", also known as management control, refers to the combination of systems, processes and procedures in place that provide "reasonable assurance" that risks will be minimized, and results maximized – whether this refers to a far-reaching social program, or a routine administrative task.

"Reasonable assurance" means just that. Any program or administrative task has inherent risks – the cost of doing business, and managers must take such risks into consideration in a cost-effective fashion. The cost of a management control must be proportionate to the risk. For example a pharmacy would keep serious narcotics (controlled substances) under lock and key, but stock the public shelves with antihistamines and aspirin.

Annual-salaried employees are trusted to keep track of their time and attendance, but additional management oversight is required for overtime payments. Program applicants submit qualifying information to caseworkers, but such information is subject to independent verification where appropriate.

Testing is a key ingredient in each state agency's "Internal Control Review", i.e., a review of management controls systems in place governing key program and administrative functions of the agency. Such testing is generally of two types:

- **Ongoing testing/monitoring** – built into standard procedures, supervisory oversight, employee evaluation and case review;
- **Periodic evaluation –** e.g., on a quarterly or annual basis, often conducted by a consultant or independent body, with emphasis on program results, cost-benefit analysis, and timeliness of services.

Internal Control Testing and Internal Auditing have much in common, which is why most state agencies have placed the internal control oversight function within their internal audit shops. The three main techniques of testing AND auditing include:

Observation – this is part of good supervision, applicable to factory assembly lines, residential programs, the classroom, workshop, kitchen, or office environments. It is especially useful when training a new employee to ensure results match expectations, and instructions are clear.

Interview – asking questions – of staff, customers, clients, vendors, or peer professionals is often the only way to get to the bottom of a situation in a non-adversarial way.

Documentation – this includes a review of items such as elevator inspection certificates, fire extinguisher recharging tags, time sheets, vouchers, program applications, day care center inspection reports, or even computer access logs.

What differentiates internal audit from internal control testing (or program monitoring, for that matter), is **auditor independence**. If you've followed the scandals of Enron, WorldCom, Parmalat and the like, you understand the temptation to tell the boss what he/she wants to hear, overlook shortcomings, or downplay fiscal irregularities. Even with auditor independence, collusion can occur (with adequate financial incentive).

Testing is a management responsibility of each division and bureau, but an Internal Control Officer needs to review the methods employed to determine if they constitute "reasonable assurance" that results are being achieved as responsibly as possible, while minimizing the downside of fraud, waste and mismanagement.

Yes, we must recognize that anytime large sums of money are involved, there is the potential for fraud – by an applicant, vendor/provider or employee. And the damages resulting from such fraud may be more than monetary. A daycare center bribes an inspector to overlook a building code or fire safety violation. A mechanic uses substandard parts to replace the brakes on a facility van. A computer vendor

[1] Almost

contracts out hard disk manufacturing to a shoddy cousin (where does lost data go?). A defective smoke alarm causes a house fire.

Internal Control Testing must keep in mind the two sides of the coin:

- What are we trying to achieve?
- What are we trying to avoid?

If a risk does not interfere with results, one needs to ask "why spend money and time trying to control such a risk." Similarly, if the risk (or "vulnerability") is highly improbable (like a Martian invasion[2]), we would only invest in controls where the impact of such a long-shot would be devastating.

Plain Talk About Testing

On a periodic basis, the Internal Control Officer (ICO) will ask you how your specific program or administrative function is going. The Survey form is quite simple, but as anyone knows, trying to sum up anything into twenty-five words or less is no small task. As Mark Twain once said "Please forgive this long letter, I didn't have time to write a short one."

You are the expert when it comes to your program or function, so the ICO will not dictate what you have to do to verify things are going as they should. But the ICO will review your submission to determine if the frequency and extent of testing you describe is proportionate to the scale and significance of the operation.

The ICO should also meet with bureaus on a selective basis to review testing efforts, and provide suggestions for improved testing, based on experience with comparable functions, and based on state and nationally recognized standards for internal control and internal audit.

"Control self-assessment" is one such standard, expounded by the COSO[3] or Treadwell Commission. Applying the control self-assessment approach for auditing, testing and evaluating program performance is an ideal process for reviewing office operations and residential programs.

Observation

Have you ever sat at a traffic light, and wondered if it would ever change. Most lights change on a 30 to 45 second cycle, but the light at the corner of Fuller Road and Washington Avenue can take an eternity to cycle through all its choices.

If you've observed something happen more than once, you develop expectations. The shop foreman on the automobile assembly line expects you to install one bumper every 4 minutes and 19 seconds. The chief account clerk expects you to process 15 vouchers per hour, regardless of their illegibility. A crackerjack typist should be able to clock 90 words per minute, provided the network doesn't crash.

As a manager, you have had to justify staffing based on a work plan that estimates the volume and complexity of activities, including individual unit times to complete an activity, with total turnaround goals established to provide timely and accurate service. **Observation** is one way to determine if reality is in sync with that work plan.

Interview

Interviewing starts when you select someone to join your operation. Of course you will also check their credentials and references, but the interview is the final determinant in hiring. Interviewing doesn't stop once a new employee signs on. During his/her probation period you will use the interviewing technique to reinforce training, to verify the employee's understanding of the processes/procedures employed, provide an opportunity for the employee to ask questions about his/her role and your perceptions if his/her performance.

[2] Them coming here, not NASA's rover.

[3] **Committee of Sponsoring Organizations –** including the American Institute of Certified Public Accountants, the American Accounting Association, Financial Executives International, the Institute of Internal Auditors, and the Institute of Management Accountants

Once an employee is well-established in an organization, interviewing continues to be used as a management technique. Changes occur – be it new trends, new technology, new mandates, staff shortages, increased workload, or new procedures. As a manager it is your job to make sure things are going as well as can be expected. Are you keeping pace with quality control and turnaround time? Are you delegating functions and authorizations appropriately. Are your customers happy? Who are your customers? People will volunteer information verbally that they will never put in writing – for a variety of legitimate or illegitimate reasons.

As a manager, you will need to filter the information received, compare it to observations of what is really happening on the job, then checking the **Documentation** to determine if allegations or suspicions are well-founded.

Documentation

Ever since the time of Moses, documentation has been viewed as a necessary evil. Ethicists rely on the Ten Commandments (yes, even in Alabama). Accountants and bookkeepers have followed the **Code of Hammurabi** longer than agency employees have followed their Policy and Procedures Manual. The Bill of Rights and US Constitution continue to be relied on, interpreted, argued and re-argued. The best ideas get written down – on clay or stone tablets, papyrus, vellum, paper, and now the new electronic media.

Your office files, be they on paper or a computer hard drive, follow a long trend in human history. Properly maintained, they can help you maintain a semblance of order in your operation, faithfully and accurately record what happened, and when. Or you can "cook your books" in support of alternative theories of reality (deficit, what deficit?).

Your first responsibility as a manager is to make sure such documentation is useful and necessary. Some types of documentation are required by law or procedure.

Other types help control the processing of a transaction from start to finish. Paper files may include signatures, date stamps, original documents such as purchase orders or vouchers, inspection certificates, and facsimiles of official records such as birth certificates, college diplomas, pay stubs and tax filings.

The modern office is in transition from paper to a paperless environment. Rather than store Xerox copies of documents, many offices now scan digital images, for on-line storage that automatically links the images with other related files (e.g. MS Word documents, Adobe PDF reports or Excel spreadsheets). More and more companies now make lengthy bills available digitally, be it an EZ-Pass account or cell phone minutes. Such digital information has many added benefits. You can "filter" a lengthy report, looking for certain occurrences (e.g., dollar amounts over $50, weekend use of cell phones or EZ-Passes), or sort data in various ways to structure specialized reports without re-keying of data.

Sampling is a common technique for reviewing documentation. Perhaps you want to check 10% of a new employee's output on a weekly basis to ensure they are doing the job right. Then you may do a 5% sample of a senior staffer on a monthly basis. Research analysts and auditors may also select a random sample of specific types of records during an evaluation or audit. When records are maintained in electronic format, you can even look for exceptions in 100% of the records, letting your personal computer do all the grunt work.

Most managers prepare monthly reports, identifying trends/problems, quantifying any backlog in processing (is it increasing or decreasing?), seeking clearance for procedural changes to cope with changing times or growing workload, even quantifying the error rate in input and output materials. Are you coping with demands of prompt payment legislation?