External Assessment of Internal/Managerial Control

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Abstract

Setting internal/managerial control systems is the responsibility of each public entity management and needs to be based on internal/managerial control standards, which list a minimum of management rules, which all public entities shall follow. Standards are grouped in internal/managerial control key items: control environment, control procedures, accounting and financial, assessment of internal/managerial control systems, internal audit etc. Internal/managerial control is an essential activity for external public audit, conducted by the Romanian Court of Accounts to establish whether public entities managers implement in practice the legal provisions concerning the internal/managerial control system.

Keywords: *control environment, accounting and financial, assessment of internal/managerial control systems, internal audit*

JEL Classification: D73, H83, O1

Introduction

This material introduces essential approaches to assessment of internal/managerial control by external public auditors, materialised in: the definitions of internal control given by various international bodies, the internal control made of good practice principles, accepted internationally and at the level of EU, procedural components, responsibilities and limitations of managerial control within the entity, assessment of managerial control by external public auditors. Control, from the semantic point of view, is a permanent or periodical analysis of an activity, a situation, in order to study its development and to take measures to improve it. At the same time, control means a continual moral and material supervision, as well as command of an activity, of a situation.

The analysis of the internal/managerial control shows that this is a management attribute, a leadership function, a means of getting to know reality and to correct errors. The most common sense associated to control is that of verification, which is frequently associated with the cognitive activity, which shall allow management to coordinate the activities within the organisation as economically and efficiently as possible. Control, from the point of view of its mission, is an inherent component of management, a specific human activity, serving management, business partner's third parties, public authorities and even population.

In 2009, in Brussels, the European Commission debated the internal/managerial control subject matter and, on which occassion highlighted the fact that after accession, many new EU member states did not dully continue its implementation and development.

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In this context, the European Commission recommended that supreme audit institutions promptly intervene, by assessing the internal/managerial control implementation in their own countries and activate its continuous and operative development.

External public auditors need to analyse whether the legal conditions required for internal/managerial control implementation and operation have been observed, whether the managers/persons managing public funds or public patrimony conduct a good financial administration, by providing legality, regularity, economy, effectivenes and efficiency in the use of public funds and in the administration of the public patrimony, in assessing the entities' activity.

1. Definitions of the internal/managerial control system

There are numerous definitions of internal control, but in essence, the various international bodies reached an agreement and, for exemplification purposes, here is a presentation of the definitions adopted by: *INTOSAI:* internal control is a managerial instrument used to provide a reasonable assurance that the management objectives are fulfilled; *The Chartered Accountants' Order of France, in 1977*: "internal control represents the totality of measures which contribute to the mustering of the enterprise. It is meant, on the one hand, to ensure patrimony protection and information quality and on the other, to implement management instructions and foster performance enhancement. It involves the organisation of each enterprise activity methods and procedures, to maintain its perennial character"; The *internal control definition in Romania is provided under art. 2 letter d) of Government Ordinance no. 119/1999* on internal control and on preventive financial control, as subsequently re-issued: "internal control – the overall control forms enforced at the level of the public entity, including internal audit, set by the management, in keeping with their objectives and with legal requirements, to ensure the economic, efficient and effective funds management; it also includes the organisation structures, methods and procedures." To adequately understand the internal control concept, seen in terms of the internationally accepted and EU good practice general principles, here is the *definition adopted by the European Commission:*

"Internal control is the set of policies and procedures conceived and implemented by the management and staff of the public entity, so as to provide a reasonable assurance for: the economic, efficient and effective implementation of the public entity's objectives; the observance of external rules and management policies and regulations; the protection of assets and information; the prevention and tracking of frauds and errors; the quality of accounting documents and timely generation of reliable information relating to the financial and management segment." Though the international and national definitions of the internal/managerial control system are numerous, they are not contradictory in kind and all highlight that it is not about a single function, but about an assembly of issues implemented by the staff in charge at all entity levels, to manage activities operation. The above definitions also highlight the fact that role of internal control involves providing entity management a reasonable assurance that the management objectives have been fulfiled. Managerial control is conceived to provide a reasonable assurance relating to institution objectives implementation, a reason why objectives need to be straightforward, a mandatory condition for an efficient managerial control.

Internal control is an integrated process, conducted by an entity management and staff and it is meant to identify risks and to provide a reasonable assurance that, in the process to attain the entity's mission, general objectives have been implemented. Internal

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control is conducted by the management and the institution's employees, in the sense that it is conducted by people, that need to be aware of their roles, responsibilities and authority levels.

The staff of an institutions is made of the management and the rest of the employees. Control does not involve doing the work of the subordinated employees, permanently conducting an excessive supervision/verification of the activity carried, setting traps to find errors. Control is an act of: assistance, guidance; verification – the person controlled needs to know that, at given periods of time, someone would check their tasks; a motivator, in the sense that the controlled person needs to understand that their work is very important and that their efforts, difficulties or performances are not ignored.

2. Representative instruments of internal/managerial control

In the field of internal control, Community legislation is made of general good practice principles, accepted at international level and in the European Union, while the modalities in which these principles are transposed is specific to each country, depending on the legislative, administrative cultural etc. context. The internal control concept also has a wider sense, being considered a managerial function, in that management finds deviation from the set targets, analyse the causes generating them and order corrective or preventive measures.

The control environment covers the general attitude, internalisation and measures taken by the management and by those in charge with governance relating to the internal control system and its relevance within the entity.

The control environment is defined according to the following elements: integrity (the quality involving having firm moral principles; verticality, honesty and sincerity; the will to do good, to work and live in keeping with a set of values and expectations; a continuous management concern for competence at the level of all the staff; "leading by example" (the management activity philosophy and style); human resources policy and practices.

The internal control procedures, within the control environment limits established by the entity management, contribute to the implementation of objectives set by it. The procedure is defined as the overall steps to be followed, the working methods set and the rules to be enforced, in order to fulfill the activity, competence or task.

In practice, these procedures are diversified and regulated by normative acts, such as: laws, ordinances, codes, charts, resolutions, methodological norms, instructions, specifications, circular forms, regulations, standards etc. *The internal control procedures can be grouped, according to their objective, into three categories:* jurisdictional, which target liability assignment; operational, which concern the procedural aspect; decision-making, which refer to competence enforcement.

The procedures listed in normative acts, either having a general applicability, or concerning wider sectoral domains or strictly specialised ones, în order to become internal procedures – elements of internal control – need to be particularised based on internal administrative acts, which consider a series of elements, such as: entity's own organisation; relationships among structural departments; information circuits; staff competences and responsibilities etc. *Procedures can indeed become viable internal control tools, provided the following important requirements have been fulfilled.* Thus, procedures need to be: provided in written documents; defined for each activity unfolding within the public entity; fully integrated in the component parts of the public entity's organisation system; updated

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on a regular basis; simple, exhaustive, precise and adapted to the specific object; brought to the cognizance of the staff involved, including under the form of computerised documents; and, obviously, well implemented.

In order to make sure that procedures are going to be well implemented, a good control needs to be conducted.

Control is the impulse of managerial action and consists in finding the causes triggering the deviations (positive or negative) ascertained and taking the required corrective or preventive measures.

In relation to the deviations causes, corrective or preventive measures may be forward-looking, organisational, coordination or even assessment-control in kind.

A strategy, however adequate, will remain a mere desideratum if certain, absolutely necessary, conditions are not provided, in order to conduct control: the existence of written procedures, for each activity unfold at the level of the public entity; assignment of competences, clearly delineated, for the fulfillment of the relevant tasks; straightforward setting of the activities, competences, assignments and objectives (expressed in quantitative or qualitative indicators) according to departments and operational and management positions; correctly setting individual responsibilities for the fulfillment of the tasks assigned.

3. Procedural elements, responsibilities and limitations of managerial control within the entity

3.1. Procedural elements

The task is the smallest individual work unit and represents the action to be performed with specialist knowledge and skills, in order to implement a primary objective associated to it; it is not possible to fulfill a task without having assigned adequate competences (*competence is the capacity to make decisions, within defined limits, to fulfill the task*); furthermore, task assignment involves establishing responsibilities (*responsibility is the obligation to fulfill the task assigned*).

Consequently, responsibility defines an obligation-based legal relationship, while the failure to fulfill it triggers sanctioning in proportion to the legal liability type.

The job responsibility is the set of tasks of the same kind, required to fulfill a well defined activity, which is periodically or continuously performed and which involves specialist knowledge and skill to implement a specific objective;

The activity consists in the totality of the job responsibilities, which determine a high degree of homogeneity and similarity work processes. The knowledge required to conduct the activity belong to limited domains, the staff involved thus having possibly rather unitary professional qualification. The activity covers homogenous job responsibilities for the entity departments;

The function represents the set of the same type or complementary activities, aiming at implementing precisely set objectives;

The post is the primary element of the organisational structure and represents the set of tasks, objectives, competences, responsibilities and procedures (*the procedure may be defined as the steps to be followed in the enforcement of the competence, fulfillment of the task and liability assignment*) which are assigned and need to be fulfilled at the level of a job;

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The position is made of all the posts with similar characteristics from the point of view of tasks, objectives, competences, responsibilities and procedures;

The department is an organisational sub-division, set by putting together, based on objective criteria, a rational number of posts that are under a unique authority, at the level of which a relatively homogenous set of tasks are being conducted, on a permanent basis and which requires specialist knowledge and skills of a certain type and the use of adequate methods and techniques;

Organisational relations are made of*: a. reporting relationships* (among management positions and operation ones, or among management positions at different reporting levels); *b. functional relationships* (among departments with competences integrated in the procedural flow of certain activities or among functional departments which have the authority to provide specifications, methodological guidance, specialist prescriptions etc.); *c. cooperation relationships* (among positions on the same reporting level, within the same department or within different departments, in view of the fulfillment of joint actions); *d. control relationships* (among the persons/departments with control competences and the other persons/departments); *e. representation relationships* (among top management positions and legal and natural persons).

3.2. Responsibilities and limitations of managerial control effectiveness

The internal/managerial control responsibilities are set for each individual party in charge within an institution, as follows: *Managers* are directly responsible for all institution activities, including drafting and implementing an adequate operation and maintaining and documenting the internal control system. Their responsibilities vary in relation to the position they hold in the institution (for example, member of the board of directors, chief accountant, member of the audit committee). *Internal auditors* examine and contribute to the internal control system effectiveness through recommendations and assessments and that is why they play a significant part in the internal control effectiveness. *The staff* directly contributes to internal control, this being, explicitly or implicitly, a part of their tasks. All staff contribute to control enforcement and are kept to report on activity problems and on infringements of the code of conduct provisions. *Stakeholders* also contribute to attaining the institutions' objectives or may provide useful information for the internal control performance, but do not have any responsibility for the implementation or operation of the institution's internal control system. *Supreme Audit Institutions (SAI)* encourage and support establishment of internal control at government level. Internal control assessment is essential for compliance, financial and performance audits of SAIs. They inform stakeholders on the audits' findings and recommendations. *The legislative and regulatory bodies* draft the rules and directives on internal control, thus contributing to a common understanding of internal control. *Other parties* interact with the institution (beneficiaries, suppliers etc.) and provide information on the latter's objective attainment.

Irrespective of how well conceived and operating an internal control system is, this may not provide management a reasonable assurance – *not an absolute one* – relating to attaining an institution's objectives or its survival, it may provide management information on the progress or absence of progress towards objectives attainment. The political changes or government programmes, demographic or economic conditions are, as a rule, beyond management control and may require managers to re-daft controls and to adjust risk

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accepted level. An effective internal/managerial control diminishes the probability that objectives are not met, but it may not turn an ineffective manager into a good one.

There will always exist a risk for internal control not operating as conceived, since internal control depends on the *human factor*, it may involve design deficiencies; assessment or interpretation errors; misunderstandings; negligence; fatigue; distraction; secret agreements; inadequate behaviour or omissions; misuse of power by persons having management, coordination or supervision competences; hedging the independence in the conduct of work competences; frequent changes in the internal and external environment of the entity; inadequate setting and implementing of managerial control procedures.

Resource related constraints represent yet another limiting factor in the design of an internal control system. Consequently, controls benefits should be considered in relation to their costs.

Maintenance of an internal control system that would rule out the loss risk is not realistic and would probably cost more than it is justified by the derived benefit. When deciding whether a certain control needs to be set up, the probability that risk emerges and its potential impact on the institution shall be considered, as well as the costs involved by setting up of the new control.

Internal control and the staff operating the system may be impacted by the *organisational changes* and *the managerial attitude*; in this context, the management needs to analyse and update controls on a permanent basis, to inform the staff on the changes operated and to set an example in point of those controls enforcement. In conclusion, managerial accountability involves the responsibility for the good financial management and performance at all levels of an entity.

4. Assessment of the managerial control system by external public auditors

The European Commission debated the internal/managerial control subject matter at the Conference of September 2009, in Brussels; on this occasion, it was shown that many of the 12 new EU member states, respectively their central harmonisation units, failed to adequately continue its development, though they were supposed to.

The European Commission recommended that supreme audit institutions timely intervene by assessing the internal/managerial control implementation stage in their own countries and activating its continuous and more operative development. In this context, internal/managerial control became a priority subject matter of external public audit; it is conducted by the Romanian Court of Accounts through the assessment of its stage of implementation by public entities' managers, by implementing in practice the legal provisions of the internal/managerial control system.

External public auditors needs to cover the following stages in the assessment of the internal control system; acquaintance with and understanding the entity and its environment, including its internal control; assessment of internal/managerial control environment; assessment of internal control risk; testing internal control mechanisms.

External public auditors need to identify, during their audit missions, the internal control systems' weaknesses of public entities and to assist in this respect the internal audit structures in the process of ruling out these weaknesses and deficiencies, to assess whether the activity unfold by public entities complies with the specific regulations in the field, with the guidelines and manuals drafted by persons in charge of the implementation of internal/managerial control.

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According to specialist documentation in the filed, supreme audit institutions have the role to make sure that the institution (SAI) plays a key role in: a) supporting the establishment of a strong internal control environment; b) assessing the internal control systems of public entities; c) enforcing internal control standards at the level of public sector entities; d) highlighting the role of internal audit as a decisive part of the entity's internal/managerial control system; e) making sure that there are norms/regulations în place, grounding the maintenance of an effective internal control in the public sector; f) encouraging public sector managers to implement effective internal controls; g) stressing the importance of internal control operation, by requesting public entities' managers to conduct periodical self-assessments of the internal control activities.

When assessing the activity of an entity, external public auditors should analyse whether legal conditions have been observed relating to the internal/managerial control implementation and operation, whether managers/persons managing public funds or the public patrimony conduct a good financial management by ensuring legality, regularity, economy, efficiency and effectiveness in the use of public funds and in the administration of the public patrimony.

External public auditors need to analyse a series of aspects:

- whether the public entities developed and maintained systems to collect, store, process, update financial and management data and information, as well as systems and procedures for adequate public information, through periodic reports;

- whether the entity manager complied with the legal obligation to provide for the establishment, approval, implementation and enhancement of organisational structures, methodological regulations, assessment procedures and criteria, to satisfy the general and specific internal control requirements (it shall be verified whether persons in charge have been appointed to draft these regulations, as well as the pertaining deadlines);

- whether the entity complied with the legal requirement to ensure management and execution staff integrity and competence, informing and making them understand the importance of internal/managerial control and whether a management and operating staff cooperation environment was provided, including by training staff accordingly;

- whether the entity managers ensured the general objectives fulfillment by systematic assessment and maintenance of structures, programmes, project or operations associated risks at an acceptable level;

- whether internal/managerial control specific objectives were established, which are specific, measurable, achievable, results-focused and time-bound (SMART objectives) and its overall objectives (which are integrated in the entity's strategy and which are provided in the articles of incorporation, respectively the manager needs to integrate the internal control specific objectives in the overall objectives of the entity);

- whether the management supervises, on a continual basis, all activities and if, whenever they find legality and regularity infringements in the conduct of certain operations or failures to conduct operations or activities in an economic, effective or efficient way, take corrective steps in a timely and responsible manner;

- whether the public entities manager complied with the obligations provided by internal control requirements concerning internal control specific objectives;

- whether the public entities manager have established structures having monitoring, coordination and methodological guidance competences relating to the managerial control system, based on an internal decision document;

- whether the public entities manager (together with the economic manager, the chief accountant, the head of internal audit department and the preventive financial

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controller) complied with the obligation to organise and conduct preventive financial control, respectively whether they complied with the legal obligation to establish the operation projects subject to preventive financial control, in keeping with law (external public auditors need to consider that the observance of legal provisions involves that before submitting the operation projects for financial control visa, there should exist, at the level of the public entities, a strategy highlighting SMART objectives (specific, measurable, achievable, results-focused and time-bound) for each department/directorate, service, office; that work procedures are in place according to activities, a risk record book has been established, that minimal mandatory standards and results and effectiveness indicators have beeing set and that the actions, associated costs and objectives considered have been listed);

- whether the legal structure legally endorsed the documents, fully complying with the applicable legal provisions. The internal control organised at the level of the public entities also includes the legality visa on the legal documents, set by the legal counselor, before being approved by the head of the public entities. It is mandatory to request this visa, but it does not involve the obligation to comply by the holder of approval competence. In case the competence holder does not comply with the visa, then the operation is conducted at their own risk;
- external public auditors need to also consider that the person managing the public entities drafts a report on the internal/managerial control system and attaches it to the financial statements of the closed budget exercise, on a yearly basis etc.

Conclusion

Internal/managerial control is an essential activity for external public audit; it is conducted by the Romanian Court of Accounts to establish whether public entities managers enforce in practice the legal provisions concerning the internal/managerial control system.

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