

Migration of Internal Control Requirements
to State Governments:
Are You Ready?

Dr. Sridhar Ramamoorti, Partner
National Corporate Governance Group

Christian Fuellgraf, Director
Global Public Sector

Presentation & Discussion Overview

- Why does the migration of internal control requirements to state government seem inevitable? Should it be?
- What have we learned from the experience with OMB A-123 and SOX 404?
- What can you do to prepare and be "in control"?
- Audience Q & A

Fundamental Insight: Change is on the Horizon!

"It is the species most perfectly adapted to
its environment that is the first to perish
when the environment changes."

--Sir Arnold Toynbee,
Professor of History, Oxford University

Internal Control Overview

Internal controls defined – COSO 1992, 2004

Internal control is broadly defined as:

"a process, effected by an entity's board of directors, management, and other personnel, that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- ***Objective/Strategy setting***
- ***Effectiveness and efficiency of operations***
- ***Reliability of financial reporting***
- ***Compliance with applicable laws and regulations"***

The Committee of Sponsoring Organizations of the Treadway Commission
Internal Control — Integrated Framework



Grant Thornton's **point of view** on internal controls

What it is.....

- A **Blueprint** for better and more efficient fiscal, program and technology management
- A **Methodology** to ensure fiscal accountability and safeguard public assets
- An **Approach** that aligns an organization's process and procedures to reporting, rules and legal requirements
- A set of **Standard Practices** to provide reasonable assurance of the integrity of all fiscal processes
- A **Means** to creating greater visibility and confidence by legislative leadership, opinion leaders and stakeholders into the fiscal and operational integrity of an agency

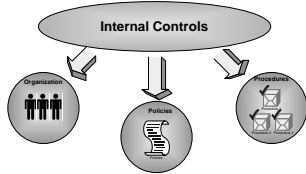
What it isn't.....

- A static, quick solution to long-term problems
- A panacea for every fiscal or management problem
- A replacement for solid managers or management
- A perfect, one size fits all, out of the box solution
- A computer application



Internal controls are a means to manage risk

Internal control is a means of managing the **risk** associated with programs and operations – done properly they are widely accepted and followed. Most employees, and even interested third parties, welcome better internal controls

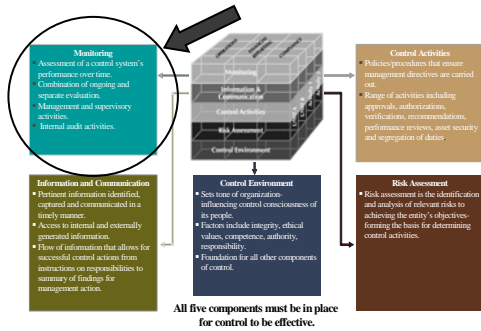


Internal controls comprise both a structure and a systematic methodology to help financial, technology and program managers achieve their mission results and safeguard the integrity of their programs

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Internal controls framework (COSO, 1992; 2004; 2006)



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Internal controls in State government

Migration to formal internal control structures

- Given their fiduciary status with respect to the public, States intuitively recognize the importance of internal controls
- With increased emphasis on transparency and accountability States are moving to a more **formal** "SOX-lite" structure
- Organizational and accountability structure as well as internal audit and review are **both** critical success factors – need integration

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Why internal controls in state government

- Fulfill campaign promises to improve government operations and eliminate fraud waste and abuse
- Effective internal control programs will save dollars for agencies
- Superior risk identification and mitigation
- Back office system upgrades and replacements
- Better operational and financial management brings many rewards
- Increased public, media and other stakeholder confidence
- Increased legislative support

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MONITORING: The risk→response→monitor→correct cycle

Forthcoming COSO monitoring guidance



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Lessons Learned About Designing,
Implementing and Sustaining Internal Controls

Best practices for internal control implementations

- Structure** ✓ Promotes accountability of public agency resources, programs and funding
- People** ✓ People committed to stewardship and technical excellence
- Process**
 - ✓ Fiscal, and services data integrity
 - ✓ Improved clarity and consistency in fiscal reporting and process
 - ✓ Proactive indicators of problems
 - ✓ Ability to react based on problem identification
- Technology**
 - ✓ Responsible use of technology tools
 - ✓ Integration of financial, non-financial data
 - ✓ Effective analytical capability
 - ✓ Be proactive when implementing ERP

S+P+P+T= robust and effective internal controls

Leadership Endorsement of Internal Controls

- Governor - it is all about the tone at the top
- CFO – Comptrollers, Budget Directors, Auditors, Treasurers (NASACT*)
- CIO – this is not just about assets, it is about information!
- Cabinet members – agency leadership must be involved and show active executive support
- Legislature – not unlike a board of directors
- CAE- Review by internal auditors

Reconfirmation of internal control operating effectiveness

Lessons learned from successful internal controls implementations

- Management's approach must be positive – so its employees are positive
 - Obtain management commitment and ownership
 - Train staff early to understand why and how
- The number of key controls is the primary cost driver
- Eliminate the silos (setting up a PMO may be necessary)
- Take an ERM approach to obtain a holistic view
- Sole reliance on independent tests of controls is the "high cost" approach
- Perform gap analysis and get outside assistance scheduled early
- Software is not the "cure-all" – need human intervention and staff involvement
- Plan for long-term sustainability - this is a continuous process

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Challenges each state and agency will face

- Potentially difficult requirement
 - Would prefer one attempt to get it right
 - Stakeholder buy-in and managing expectations
- Resource issues
 - Staff levels and availability
 - Staff familiarity and experience with internal controls
 - Appropriately customized IT systems and infrastructure
 - Funding for outside support
- Decentralized or large operating environments have special considerations
 - Extent of autonomy with strength and role of a central office
 - Extent of uniformity or existence of processes
 - Utilization or adoption of controls particularly across regions or divisional boundaries

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Opportunities

- Effective internal control programs will save dollars
- Superior risk identification and mitigation
- Increased public, media and other stakeholder confidence
- Increased legislative support

Internal controls are the very DNA of enterprises--analogy to immune defense systems

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Fundamental Insight: Create Your Own Future!

Planning without Action is FUTILE,
but
Action without Planning may be FATAL!

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Conclusion

Thank you!

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Appendix

Additional information

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About Grant Thornton

- 5th largest of the global accounting and consulting firms
- More than 25,000 professionals around the world
- 50 Offices in the United States
- Recognized thought leader in the implementation of internal controls across government and industry
 - COSO commissioned Grant Thornton to develop guidance to help organizations monitor the quality of their internal controls systems.
- Global Public Sector Consulting Practice based in Alexandria, VA
 - Recognized as a leader in the implementation of internal controls at federal agencies.

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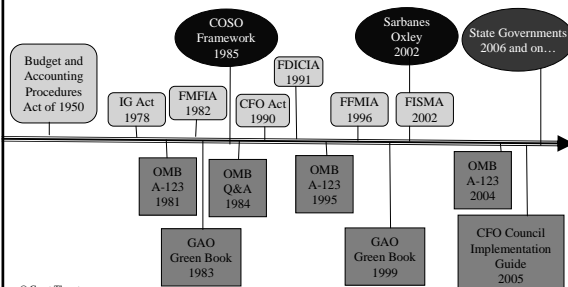
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The Committee of Sponsoring Organizations of the Treadway Commission *Internal Control*
– *Integrated Framework*

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Evolution of Internal Controls: "Greedy algorithm"



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Additional lessons learned

What lessons have adopters learned that would be of interest to agencies complying with ARMICS requirements

- **It is never too early to begin the process** - Some first-year adopters started too late and had difficulty meeting deadlines. Some experienced delays in system implementations and accounting consolidations. Others found their merger integration plans affected. Still others experienced resource shortages. Many reported that angst existed between management and auditors. The root cause of many of these issues was starting too late.

- **It will always take longer than you think** - Estimates to complete the work were grossly underestimated, from the beginning and throughout the process. For most first adopters, there were too many fire drills. Guidance was issued too late, so first adopters operated for a long time without a clear articulation of the task. The lack of a risk-based approach led to huge subjective scope creep. Documentation took longer than anyone expected.

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Additional lessons learned

- **The number of key controls is THE primary cost driver.** Too many agencies tested too many controls. This area should be a prime focus of attention during the second year. A top-down, risk-based approach is best practice. The top-down approach evaluates the control environment and general IT controls first, rather than as an afterthought. Under a risk-based approach, management should ensure that the agency's risk assessment process is effective in considering quantitative and qualitative factors. Filtering to determine the key controls is important, as not all controls need to be tested. The criticality of the controls to achieving financial reporting assertions is an important consideration.

- **Sole reliance on independent tests of controls is the "high cost" approach.** Internal control evaluation is not a "one size fits all" approach. The "reasonable assurance" standard implies "a range of acceptable conduct," suggesting the potential for different approaches given an agency's facts and circumstances. For example, independent tests are only one source of evidence. Self-assessment and agency-level and process-level monitoring are other sources of evidence and should be deployed as an integral part of a balanced testing plan. A balanced approach is the preferred approach.

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Additional lessons learned

- **There were many good things that happened.** For example, the quality of financial reporting improved as control deficiencies were remediated. The CFO and the finance function improved their influence and stature in the organization and with the political leadership and outside interested parties. Oversight and Audit Committees were more engaged and supportive of finance. Not only did a lot of people at all levels get educated about risks and controls, there is now more discipline around internal controls at many organizations.

- **Get outside assistance scheduled early.** A lack of experienced resources affected everyone. Resources are expected to continue to be scarce over the next 12 months.

- **Management's approach should be positive – so its employees are positive.** The tone at the top is important.

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Sustaining an Internal Controls Program...1



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Sustaining an Internal Controls Program...2

- Prior to OMB Circular A-123, a prevalent misconception was that "getting the financial statements right" was the responsibility of the independent auditor
- Unfortunately, even the best audit process cannot compensate for a poor financial reporting process (GIGO: you can't make a good omelet out of bad eggs!)
- It falls to the policies, procedures, people and technology that **management** puts in place:
 - to maintain a proper tone at the top and
 - create a culture of excellence and integrity in which
 - there is reasonable assurance that the financial statements are right in the first place

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