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The Case for Better Internal Control in Our Government Organizations

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JUST TWO DAYS before Christmas in 1952 the head cashier of one of the County Treasurer's offices in our state sat down with the County Attorney, a court reporter, and his boss, the County Treasurer, and confessed that he had embezzled about \$48,500 from the County over a period of three and one-half years. His defalcation had come to light when a taxpayer brought a canceled check to the office to prove that he had paid his property taxes. The Title company had charged him with the taxes the second time when the property was sold. Christmas 1952 must not have been a very happy holiday for this father, his wife, and five children. He was arrested, tried and convicted, and given a sentence of from five to ten years in the state prison. The bonding company paid part of the loss, but the law required the County Treasurer to make up a substantial portion of it out of his own pocket. A bill was introduced this year in the State Legislature that would give the County Treasurer about \$20,000 as reimbursement, but it died in Committee.

In 1944 headlines of local newspapers informed the people of our state that a long-time, respected political figure who had held the office of County Assessor, and two of his key employees, were charged with misappropriating some \$56,000 of taxpayers' funds. After reading the court record and the newspaper accounts of the trial it is easy to reach the conclusion that the real total was undoubtedly substantially more. It was an interesting trial. Each of the accused tried to shift the blame to the others, but at the end the jury found them all guilty. The Assessor, who since had been elected State Treasurer, and his cashier, a woman, were sent to jail. His Chief Deputy received a suspended sentence, presumably because he turned state's evidence.

In 1957 it was discovered that another employee, this time the Chief Accountant of one of the state's large agencies, had taken more than \$70,000 of state funds during a period of some five years. This defalcation was uncovered in the agency's first full audit in thirteen years. The employee confessed and at the conclusion of his

trial was given a sentence of six to ten years in the state penitentiary. The state recovered \$34,000 on the bonds.

Just within the last couple of months the newspapers have been reporting the second trial of another County Treasurer in our state who had been charged with embezzling about \$55,000. The verdict in the first trial was set aside by the Supreme Court, and the second trial resulted in a hung jury and the case must be retried.

About two months ago an article in the local newspaper carried the headline, "Irregular School Payments Revealed." The article said that an audit of school expenditures in one of our counties, made by the State Examiner and going back to 1951, disclosed improper expenditures in many categories: personal items, professional dues, personal professional convention expenses, medical fees paid to students, payments to teachers and school administrators in excess of their contracts, and other irregularities. (Parenthetically, I might ask the question, Why should any audit have to go back ten years? I think that taxpayers and school administrators should be entitled to an audit every year.) Last month there was another article in the press stating this time that the State Examiner had criticized school officials and teachers from another county (and the names of these people were given in the article) for certain other expenditures made during the past five years. There have been many similar articles in the newspapers over the past few years. In fact, such irregularities in the schools seem to be almost a regularity.

From my own recollection I could extend this list of defalcations and reports of improper use of public funds in Arizona to quite some length. I expect most anyone else who has lived in Arizona for a few years could add to the list. In every one of these cases there has been embarrassment to the people who were accused, their families, co-workers and friends, possibly their political parties, and the officials of the agencies concerned. Some of the cases were real tragedies. Many thinking people in our state must have asked questions when they read these stories. Was something wrong that these frauds and irregularities were allowed to happen? Was there not a way they could have been prevented? The old saw, "An ounce of prevention is worth a pound of cure," is so true. Far better it would have been if the embezzlers had been protected from their own weaknesses, and if routine procedures could have forestalled the other irregularities. I am sure that proper organization and accounting arrangements would have prevented losses, or at least would have

detected them at an early date, in every one of these cases. Methods, procedures, and devices used to accomplish this vital purpose—prevention of such losses—are included in the very important subject called *Internal Control*.

INTERNAL CONTROL DEFINED

The term *Internal Control* may sound as though it belongs in the medical field, but it doesn't. It belongs to the accountants. The most often quoted definition of the term appears in a bulletin entitled, "Internal Control", which was published by the American Institute of Certified Public Accountants. This bulletin was a special report of the Institute's Committee on Auditing Procedure. It says, *Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.* In less technical language, what does this mean?

On a number of occasions when I have tried to explain to non-accountants the meaning of internal control, they have responded with a remark something like this: "What you are talking about is a system of 'checks and balances' within the accounting system." *Checks and balances*—that is a rough, somewhat incomplete explanation, but it conveys the general idea. In an accounting system with good internal control, the work of one employee or department more or less automatically checks the work of another. Such a system leaves little chance that someone will make an important error, misappropriate assets, or fail to perform his duty properly without a red flag waving somewhere to be seen by another person who has the power and inclination to do something about it. Just a few common everyday examples may help explain the meaning of the term: requiring two signatures on a check for withdrawal of funds, requiring approval of an invoice by a responsible person before payment, putting a fence around the materials yard. All of these are internal-control measures.

PURPOSES OF INTERNAL CONTROL

That a good internal-control system will minimize losses and improper use of funds or property is true, but it also will perform

other important duties. Recapitulating the four principal functions mentioned in the Institute's definition, we have: (1) safeguard assets, (2) check the accuracy and reliability of accounting data, (3) promote operational efficiency, (4) encourage adherence to prescribed managerial policies.

SAFEGUARDING ASSETS

Most of us are painfully aware that losses from embezzlements and similar frauds have reached astonishing proportions. The other day we saw a news story of another million dollar bank embezzlement. Recently I read that American business losses from embezzlements and similar irregularities have been estimated to range from one to three billion dollars annually, while U. S. Police reports to the FBI listed the value of properties stolen in 1957 by robbery, burglary, larceny, and auto theft as \$272 million.

The independent post audit is a very important weapon against losses from internal frauds, but officials have not discharged their responsibility by asking for an independent audit. The primary responsibility for preventing defalcations and safeguarding the assets of the organization still rests with the management. It is their duty to see to it that the accounting system and procedures are adequate to preclude losses. I have often said that frequently the most valuable service an independent auditor can give to his client, particularly in his first audit, is pointing out internal-control weaknesses and suggesting methods for correcting them.

Under the heading of safeguarding assets comes problems of physically protecting the properties. Fences, safes, safety deposit boxes and similar devices are used for this purpose. Procedures that make sure all claims and receivables are properly recorded and followed up for collection belong in this category. So do those accounting methods that reduce possibilities of payment of duplicate bills, or payment of unauthorized, exorbitant or fictitious charges.

CHECKING THE ACCURACY AND RELIABILITY OF ACCOUNTING DATA

The internal-control system can prevent errors in the accounting figures, or disclose them.

In our modern, complex, financial world it has become necessary for those who manage our businesses and governments to depend on accounting data and reports. Financial transactions have become so numerous and so large and occur with such rapidity in many organ-

izations that it is impossible for the administrators to know personally in detail what is going on in the areas for which they are responsible. To do their job right, legislators, board or commission members, councilmen, governors, superintendents, heads of departments, and other officials must have reliable information. Some say the public is the real boss of government. Then the public must have accurate data on which to base its opinions.

Our governments today are big businesses. The Federal Government's financial activities dwarf those of any private business enterprise in our country. The annual budget for the State of Arizona is now in the neighborhood of \$200 million. Maricopa County's expenditures are over \$20 million a year, and Pima County spends over \$10 million. The City of Phoenix budgets more than \$35 million, and Tucson's budget is not too far from \$15 million. The elementary and high schools of the state spend more than \$150 million a year. I do not have time to mention each city and town, the universities and colleges, and others, but they have budgets too. I repeat, our government organizations are big business. Inaccurate data can cause faulty and costly decisions, so it is a big and important job of the internal-control system to make sure that the decision-makers receive reliable information on which to base their opinions.

PROMOTING OPERATIONAL EFFICIENCY

The internal-control system can promote efficiency of operations. We need efficiency in government. Someone has facetiously remarked that government will only trim its expenses when it decides taxpayers cannot be trimmed any more.

Reports can be designed to highlight deviations from predetermined standards and point out trouble areas. With this information at hand, corrective actions can be taken. If it is properly performed, the budget process can be a very effective internal-control measure in promoting operational efficiency. This is so when all proposed expenditures are carefully considered and are required to be justified in the light of their values. A budget is a method of worrying before you spend instead of afterward.

I know that many government agencies have taken steps in the direction of using their accounting systems to measure and promote efficiency in their operations, but it is my impression that in many places the surface has not even been scratched. This seems like an excellent field for constructive work by those officials and employees

who desire to make a mark for themselves and contribute to the progress of their agencies.

ENCOURAGING ADHERENCE TO PRESCRIBED MANAGERIAL POLICIES, OR LAWS

The internal-control system if properly designed will encourage obedience to the policies, rules, and procedures that have been adopted by those who control it. In a governmental organization this function is especially important because we are talking about obedience to laws. How many of the school-district expenditure irregularities reported by the State Examiner would have occurred if there had been an effective preaudit of expenditure claims based on a written manual that codified the financial laws and rules that school districts must follow? If there had been an effective procedure, claims that did not comply would have been rejected in the first instance. If there were differences between the school people and the State Examiner in the interpretation of the laws or financial rules by which the schools were to be judged, these could have been detected and resolved before transactions occurred (and not some five or ten years after) thus saving much embarrassment.

OTHER BENEFITS FROM INTERNAL CONTROL

There are other benefits from an effective system of internal control. A good system can reduce the cost of the independent audit. In setting up his audit program the independent auditor studies the internal control and gears the extent of his verification work to his appraisal of its effectiveness. If the controls are good, less work is required, and the audit cost is lower.

Here is another important benefit: If the financial controls of a particular governmental agency are businesslike and the public knows it, they will have more confidence in those who handle its affairs. Governmental officials need all of the confidence and respect of taxpayers and the public that they can command. A good system of internal control is an effective argument against unjust criticism. A good way to commit political hari-kari could be not having a good internal-control system.

ACCOMPLISHING EFFECTIVE INTERNAL CONTROL

Good internal control in any organization is accomplished primarily through (1) the strategic assignment of duties and responsi-

bilities among the accounting and other personnel of the organization, (2) the selection and training of qualified personnel, and (3) the proper design of accounting methods and procedures, records, and reports.

Most of the many internal-control rules seem to be founded on the premise that the bookkeeping activities should be independent of both the operating activities and the custodial activities of the organization. Operating people should not keep the records of their own performance; and people who have physical or effective control of assets should not also keep the records on those assets. This general rule assumes that the independence of the people engaged in the actual transactions and those recording them will bring to light misrepresentations, and misappropriations; and that even the threat of such a result, barring collusion, will encourage responsible performance by each of the parties.

The general rule must be implemented, of course, by various techniques and devices. There are, and probably will continue to be, as many of these as the ingenuity of man can develop to fit particular circumstances.

ASSIGNMENT OF DUTIES AND RESPONSIBILITIES

A good organization plan is basic to a good system of internal control. There must be an appropriate division of duties and a plan of review and approvals. Authority and responsibilities must be clearly defined and understood. Responsibility must be commensurate with authority, and vice versa. Don't give a boy a man's job or a man a boy's job.

Organization charts, flow charts that trace the paperwork through the organization, and procedure manuals are good tools in establishing and maintaining an organization plan that will contribute to effective internal control.

QUALIFIED PERSONNEL

Of course, no system of internal control, regardless of how brilliantly conceived, will function properly unless it is staffed with people who are capable of performing the required duties and assuming the necessary responsibilities. It is not sensible to give an experienced bookkeeper who is not trained in automotive mechanics the job of repairing automobiles, nor should a good salesman with little or no accounting training be given a responsible position in the bookkeeping organization. This seems obvious, but comparable situations

seem to occur quite often. Government, as well as business, must be careful in the selection of its personnel. It must be sure that the men it hires have experience, technical training, and personal qualifications commensurate with the positions they are called to fill. Sometimes this means higher salary costs.

ACCOUNTING METHODS AND PROCEDURES

The accounting records themselves not only accumulate the financial history of the organization, but they can be used to contribute substantially to the internal control. Double-entry bookkeeping, which is standard accounting for all types of businesses and organizations, must be a bedrock essential. There should be controlling accounts in the general ledger against which individual accounts in subsidiary records are periodically balanced. How this very simple, yet very effective, internal-control device can be overlooked is hard to understand, but apparently it sometimes is. Every county in this state should have taxes-receivable controlling accounts in their general ledgers against which the total of the individual taxpayers' receivable accounts are periodically balanced. I hope every county does.

The accounting system should include intelligently designed reports that fill the needs of management, and preparation of these reports should be a routine part of the bookkeeping. The accounting work for any month is not complete until the reports are on the boss' desk.

The right machine to assist in the accounting work can contribute materially to good internal control. In this day of computers, punch-card and numerous other complicated accounting machines, the task of selecting the right one is no job for an amateur. If there is no one in the organization who has proper training or experience in this field, the organization may realize a very good return on the dollars invested in the advice of a qualified independent consultant who can advise which machines to buy and how to build an accounting system around them to get the most out of them for the least cost.

LIST OF COMMON INTERNAL-CONTROL PROCEDURES

I wish I could include in this paper a comprehensive list of internal-control procedures and techniques that are likely to be useful in many government offices, but a list touching on all areas would be much too long. Since nearly all government agencies are responsible for cash, and this asset is considered most vulnerable, I will recite

a few of the more common cash-handling rules. The list is not complete, and the procedures are not practical in every case but should be followed if at all possible.

As to cash receipts :

Definitely fix the responsibility for handling cash.

Deposit all receipts intact, daily or at frequent intervals.

If handwritten receipts are used, use prenumbered receipt forms, with someone independent of the person receiving cash, accounting for all numbers and comparing the receipts totals with the bank deposits.

If cash registers are used, an independent person should compare the locked-in totals with bank deposits.

Allow as few persons as possible to handle cash between its receipt and deposit.

The cashiering duty should be assigned to someone who does not keep the books, or the accounts-receivable records. Contrariwise, bookkeepers should not have access to cash; neither should they open the mail, relieve the cashier at lunchtime, or assume any other of the cashier's usual duties.

Incoming cash should not be commingled with other cash used for making disbursements or cashing checks.

Require payments to be made to the cashier only, or through the mail. It is not the proper function of such persons as traffic patrolmen, business license inspectors, or personal property assessors to collect money.

Returned checks should be handled by someone who has nothing to do with their original receipt and deposit.

Persons handling cash should not have access to securities, or assets easily convertible into cash.

Safekeeping devices, such as safes, should be provided to protect cash on hand.

As to cash disbursements :

Use prenumbered check forms, accounting for all numbers.

Spoiled checks should be voided and retained.

Require two signatures on each bank account.

If it is not practical in some instances to require two signatures for the bank, establish an account with a limited balance to be

reimbursed on presentation of appropriate supporting documents.

Do not sign checks in blank.

Employees should not sign checks payable to themselves.

Checks should be accompanied by approved disbursement vouchers when presented for signature. The supporting documents should be canceled to prevent their reuse.

Someone who does not write checks or sign them should receive the bank statements from the bank and should reconcile the account.

If checks are signed mechanically, signature plates should be controlled.

Payroll checks should be delivered by some person other than the one who prepares them or upon whose records or authority they are based.

As to petty cash funds:

Fix the responsibility for each fund.

Establish funds on an imprest basis, requiring signed tickets that are reviewed by someone at the time of reimbursement.

Provide an amount that is adequate for routine needs, but is not excessive.

These cash-handling procedures indicate the nature of internal-control techniques that may be applied to other accounts such as investments, receivable, inventories, and property. In actual practice, the internal-control system must be tailored to fit the organization and its circumstances.

DIFFICULTIES IN INSTALLING ADEQUATE INTERNAL-CONTROL SYSTEMS

It is surprising that more thought has not been given to the subject of internal control by some of our governmental organizations. Admittedly, in any large complex organization, as some of the agencies are, to design an accounting system that will achieve the maximum of internal control at a minimum of cost requires considerable skill and a great store of knowledge. But this is no reason why the most elementary procedures and devices cannot be utilized.

Possibly in some offices there is not an understanding of the

problem or the competence to install proper measures. In some cases there may be a reluctance to make the necessary changes for personal reasons. Those who have the technical ability may be unable or unwilling to oppose the natural resistance to change that seems to be characteristic of most of us who have learned to do a task one way and do not care to learn another. Sometimes the failure to act might be blamed on another human characteristic common to most of us. We like to trust our associates and we may not like to suggest, even for a moment, that we think their work should be checked because they may be making mistakes or they might not be entirely honest. It is my conviction that those who are in a position to do so have a positive duty to see that good internal control is part of the organization of their office, and that this duty is so important that the lack of personal courage or an abundance of good will toward associates cannot be a good excuse for failure to speak out for the required changes. Actually, we do our fellow employees a great favor by insisting on adequate internal control.

Sometimes the cost of establishing an effective internal-control system is given as the reason one is not adopted. It is true that there may be a point at which the cost of maintaining some measures will exceed the benefits derived; however, this point must be determined only after very careful consideration of all the facts and possibilities. Ordinarily the smaller the organization, the more difficult it is to set up satisfactory control, but there should be no early conclusion that to accomplish the end desired will require the hiring of another person in the office or additional expense. In my experience I have noted that with a little ingenuity and knowledge some of the most important internal-control techniques can be incorporated into the accounting system without any increase of cost. This is true in a large percentage of the cases. It should be remembered that the cost of installing and maintaining a system of internal control may not be as great as the cost of not having such a system. Witness the cost of not having good control in the defalcation cases mentioned at the beginning of my paper. These losses were discovered. How many were not discovered?

Seldom, if ever, can we expect 100 per cent protection from the system of internal control; as long as people are people, with their human frailties and limitations, there will be uncaught errors, and there will be unscrupulous individuals who will find ingenious methods to beat the system, at least for a while. But the difficulty of achieving

perfection should be no excuse for not utilizing known techniques to reduce unfavorable possibilities to a minimum.

WEAKNESSES IN THE SYSTEM OF INTERNAL CONTROL IN CASES MENTIONED

It might be interesting to "post-mortem" briefly the defalcations mentioned at the beginning of my paper, calling attention to the inadequacies of internal control and pointing out procedures that might have prevented these sad experiences. In making such an analysis, I am handicapped to some extent because the information at my disposal is only what was present in the files of the court and in the newspaper accounts. I did not have a first-hand look at the actual system in operation.

COUNTY ASSESSOR'S OFFICE

The County Assessor establishes the valuation of real and personal properties for property tax purposes. In our case he also collected taxes on personal property. The Assessor, the Chief Deputy, and the Cashier collected substantial sums that they did not turn in to the County by giving taxpayers unnumbered receipts for the payments they received. According to the Statement of Facts on Conviction in the courthouse records, they were thus able to avoid detection by the State Examiner whose "... method of examination ... was to total the sums of numbered receipts and to check this total against the total remittances to the County Treasurer ...". The Statement also said that "... in order to secure cash for these unnumbered receipts and statements stamped 'paid' these three defendants gave proceedings said that for a period of thirty-one months only one deposit included any currency (this was \$53 in coin), all other items in the deposits being checks. One of the defendants stated that a bound book showing each taxpayer's account for a period of four years was kept in the office for a while but was discontinued in favor of a system in which the only record of a taxpayer's account was a copy of the Cashier's receipt because the Assessor said, "... it showed too much of the taxpayer at one time."

What was wrong with the internal control? First, the Assessor and his key employees made assessments, kept the receivable records and collected cash. This is a clear violation of the rules of internal control. Next, it is evident that the County's general ledger had no

taxes-receivable controlling accounts that controlled the individual personal property taxes-receivable accounts. If the Assessor had valued the property and the Treasurer had collected the money, with County bookkeeping office recording the tax bills and collections in accounts-receivable records and controlling accounts, the defalcation would not have occurred.

COUNTY TREASURER'S OFFICE

The Cashier in the Treasurer's office started borrowing funds from property redemption money that was held in the cashier's cage until its disposition was determined and a receipt was written. When this source became insufficient to meet his needs he started substituting checks received through the mail in his deposit to offset currency he had taken; but this left mail payments unsupported by receipts, and such receipts were necessary if the taxpayer's records were to be credited since other people in the office posted these accounts from the Cashier's receipt copies. To solve this problem the Cashier wrote receipts and simply increasing the total of an item called *cash items* on his report to balance. *Cash items* were supposed to be items paid out by the Cashier for jury warrants and certain expenditures, pending reimbursement by the County Supervisors. Toward the end of the several-year period during which he took funds, his daily report showed some \$45,000 to \$50,000 in cash and *cash items* on hand that were not there. He told the County Attorney in his confession that he knew his system was not foolproof, that he just lived from day to day never knowing when somebody was going to come in and say, "Let us see your cash items," or when some taxpayer would come in who had not yet received a credit on his account and ask for an explanation. This is what finally happened.

What was wrong? First, procedures should have required the Cashier to deposit all of each day's receipts intact, with only a minimum standard cash-change fund retained in the cage. All funds received currently should have been deposited, including such items as the property redemption money and the mail receipts. If, for some legal or other reason any receipts could not be deposited immediately, these should not have been available to the Cashier. With a minimum standard change fund, the Cashier could not carry many *cash items* before he would have to ask for reimbursement. It would have been even better if some other person had handled the paid-out items through another fund on an imprest basis. Next, someone should

have checked out the Cashier's cash and reports frequently, preferably daily. The Cashier's confession indicates that an internal audit procedure was programmed but it was not effective because it was not carried out properly. Apparently a quarterly cash count was made by the Board of Supervisors' bookkeeper but this was not on a surprise basis. The Cashier said that he covered shortages on the days of the cash count by showing a deposit in transit on his report. It is apparent that the County bookkeeper failed to reconcile the bank account at the same time, otherwise he would have discovered that the deposit in transit was not bona fide.

STATE AGENCY

The Industrial Commission Chief Accountant took funds by having warrants drawn for the payment of bills that the state did not owe. Generally these claims were supported by false invoices, but occasionally there were no invoices, and sometimes the payee was a fictitious person. The Chief Accountant had duties in approving the warrants so when they came across his desk he retained those with which he had paid the false claims. He endorsed the name of the payee, then his own name, and deposited them in his personal bank account. He had charge of the Commission bookkeeping and thereby had the ability to control the entry of the items. When the warrants came back from the bank he would alter his own endorsements to some other name that was similar to his so that someone looking at them would not notice his name frequently.

What was wrong here? Mainly, the system for preaudit of disbursements was inadequate or was not working. Further, the Chief Accountant had duties in connection with the payment of bills and was in a position to falsify the disbursements and general records.

OTHER

There have been other interesting, extremely weak internal control situations in our governmental agencies of which I have had knowledge, but I do not have the time to tell about them now.

CONCLUSION

I think it is highly important that all governmental officials, all employees who have financial responsibilities, and the public in general realize the critical importance of adequate internal control. To me, this is one of the greatest needs in our governmental financial

organization today. In my thinking, the standards of fidelity and security in handling public finances must be even higher than those of privately owned businesses. The need for sound information on which to base the large and far-reaching financial decisions that must be made by our government officials is extremely great. Frankly I am not convinced that there is a full understanding or conviction of the importance of good internal control. Someone has said that there should be more pruning and less grafting in government. If this applies to government it applies to many of our private business organizations too. Better internal control is the answer. I hope that each of you will lend your active support to the cause of improving internal control in our governmental organizations when you return from this Institute to your office and responsibilities.