

# INTERNAL CONTROL

## IN A NUTSHELL

- The heads of the government agencies are responsible for ensuring that all resources entrusted to them are managed and utilized properly and effectively. Thus, the agencies must set up robust internal controls and establish internal audit functions.
- Internal control and internal audit have been enshrined in Philippine laws since the 1960s. In recent times, the DBM, together with partner-agencies, has been putting flesh and bone to the policy for internal control and internal audit, through:
  - The [National Guidelines on Internal Control Systems](#) (NGICs), issued in 2008, which provide guidance to agency heads in strengthening their internal controls
  - The [Philippine Government Internal Audit Manual](#) (PGIAM), issued in 2011, which assists agencies in establishing their internal audit functions
  - Initiatives since 2010 that focus on creating awareness and capacitating the bureaucracy for NGICS and PGIAM, and in setting up internal audit services or units (IAS/IAU) in agencies.
- The 2016 PEFA assessment notes that key indicators pertaining to the strength of internal controls have improved. The potential of internal controls and internal audit as good governance tools can further be actualized through the following:
  - DBM's current updating of generic manuals on controls pertaining to human resource management, quality management, and risk management systems
  - The scaling up of the PFM Certificate Program to include internal control and internal audit, and the establishment of means to assess the impact of trainings conducted
  - The government's measurements of the baseline strength of the agencies' internal controls and internal audit
  - The newly established the Office of the Comptroller General in the DBM, aimed at strengthening its oversight function on the agencies' internal control and internal audit systems



The heads of the government agencies are responsible for ensuring that all resources entrusted to them are managed, expended, or lawfully utilized and safeguarded against loss or wastage to ensure efficiency, economy, and effectiveness in the operations of government, as provided under Presidential Decree (PD) 1445, s. 1978, as amended.

Internal control, including internal audit, provides the foundation for stronger accountability and good governance in public service organizations.

Specifically, internal control refers to an organization’s plan and all the coordinated methods and measures adopted within an organization or agency to safeguard its assets, check the accuracy and reliability of accounting data, and encourage adherence to prescribed managerial policies. Moreover, the existence of a strong and responsive internal control system in an agency can significantly enhance the integrity of its operations, as well as improve its organizational outcomes to achieve the sectoral goals. In addition, it can lead to the attainment of the following:

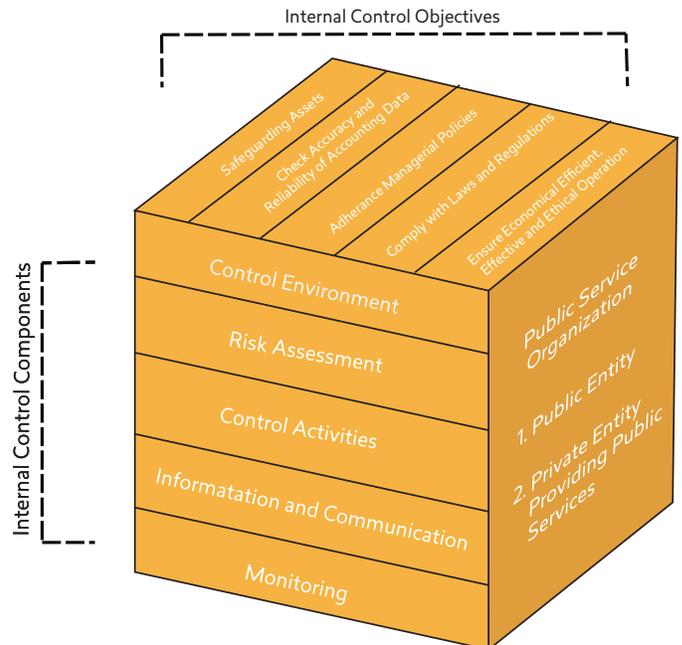
- Stronger accountability;
- Ethical, economical, efficient, and effective operations;
- Improved ability to address risks to achieve general control objectives;
- Better systems of responding to the needs of citizens; and
- Quality outputs and outcomes and effective governance.

To achieve these objectives, the agencies need to set in place the five interrelated components of internal control: i) control environment, which is the scope and coverage of an organization’s internal control system that impacts on its structural and operational framework; ii) assessment of risks that an organization faces as it seeks to achieve its mission; iii) control activities, or strategies to mitigate such risks; iv) information and communication, which are vital to managing and controlling the agency’s operations; and v) continuous monitoring and improvement of the effectiveness of controls in ensuring that internal control remains attuned to the changed objectives, environment, resources and risks (INTOSAI, 2004).

The interrelated and direct relationship of said internal control objectives with the internal control components are shown in the following Internal Control Framework:

Figure 1.

Internal Control Framework as prescribed in NGICS



Source: NGICS Framework 2012

On the other hand, internal audit, as an integral component of an agency’s internal control system, supports the management, through independent and objective assessments of the functioning of internal controls, to help monitor the effectiveness of internal control and identify points for improvement. It is a strategic function in ensuring good governance throughout the bureaucracy, hence, helps establish transparency and accountability.

Schick (1998) defines internal control as a form of expenditure control<sup>1</sup> which frees the managers of the agencies from having to obtain prior authorization from a central government body before taking action. Still, internal control requires them to comply with uniform standards in the management of resources or inputs and, thus, still constrains them from exercising broad discretion.

## EVOLUTION OF INTERNAL CONTROL AND INTERNAL AUDIT IN THE PHILIPPINES

### A Long History of Strengthening Agency Accountability

Internal control and internal audit in the Philippines have been enshrined in its laws since the 1960s.<sup>2</sup> In contemporary times, the Constitution itself and key statutes provide the broad legal framework for internal control and internal audit. Promulgated during Martial law, the Government Auditing Code of the Philippines (P.D. No. 1445, s. 1978) made agency heads directly responsible for installing, implementing and monitoring sound internal control systems.

The Administrative Code of 1987 (E.O. No. 292) also emphasized the agency heads' responsibility of ensuring that all resources are managed and utilized lawfully, safeguarded against loss or wastage and to ensure the most efficient, economical, and effective operations of the government. The said E.O. also established the Internal Audit Service (IAS) of key departments, such as the DPWH.

The subsequent issuances of the government which provided measures to strengthen internal controls and internal audit are as follows:

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| <ul style="list-style-type: none"> <li>• <b>Administrative Order (AO) No. 119, s. 1989</b> – directed government entities to strengthen their internal control systems in their fiscal operations and organize systems and procedures, in coordination with the DBM</li> </ul> | <ul style="list-style-type: none"> <li>• <b>Memorandum Order (MO) No. 277, s. 1990</b> – directed the DBM to promulgate the necessary rules, regulations and circulars for the strengthening of internal controls of government agencies</li> </ul> | <ul style="list-style-type: none"> <li>• <b>AO 278, s. 1992</b> – mandated the head of the agencies to organize the IAS as an integral part of their organization</li> </ul> | <ul style="list-style-type: none"> <li>• <b>AO 70, s. 2003</b> – reiterated the authority for the creation of the IAS and its functions</li> </ul> |
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In view of the foregoing, the DBM issued Budget Circular No. 2004-4 and Circular Letter (CL) No. 2008-5 to provide the guidelines in the organization and staffing of IAS in agencies concerned.

## RECENT MEASURES TO STRENGTHEN INTERNAL CONTROLS AND AUDIT

### A Comprehensive Guide for Internal Auditors

Recent efforts in 2008 that were continued under the outgoing administration sought to strengthen the internal control systems and the internal audit functions of the government. In particular, the DBM sought to address policy and organizational gaps and help strengthen the capacity of the agencies for internal control and internal audit.

### National Guidelines on Internal Control System

To guide the heads of the departments and the agencies in strengthening their respective internal control systems to better respond to the requirements of the publics they serve, DBM issued the National Guidelines on Internal Control Systems (NGICS) in 2008 through DBM C.L. No. 2008-8 dated October 23, 2008.

The NGICS, which contains the fundamental principles, policies and general standards, guides the heads of the agencies in designing, installing, implementing and monitoring their respective internal control systems, taking into consideration the requirements of their organization and operations, for better governance.

The NGICS likewise seeks to, among others, strengthen accountability and ensure ethical, economical, efficient and effective operations. Further, it intends to improve the quality and quantity of outputs and outcomes and enable the agencies to better respond to the requirements of the publics that they serve.

Specifically, the NGICS provided the components of internal control by surfacing the Internal Control Framework (see Figure 1).

### Philippine Government Internal Audit Manual

The DBM issued the Philippine Government Internal Audit Manual (PGIAM) through DBM CL 2011-05 dated May 19, 2011, to strengthen the establishment of the internal audit function in all government agencies. The manual complements the NGICS,

The Manual primarily aims to assist agencies in establishing their internal audit functions to promote, among others, effective, efficient, and economical operations in government. It also serves as a generic guide for internal auditors to understand the nature and scope of the internal audit function in the public sector, including the institutional arrangements, protocols, and processes for the conduct of internal audit.

The PGIAM also helps internal auditors in identifying and prioritizing potential audit areas for appraisal, as they progress in the internal audit activity and describe the procedures logically from one activity to another to facilitate a structured and systematic approach in auditing.

Further, this manual clarifies the structural arrangement and administrative relationships in organizing the internal audit, detailing the process related to supervision, reporting lines, and qualifications of internal audit personnel, as it clarifies that the scope of internal audit is broad and encompasses the appraisal of the adequacy of internal controls, the conduct of management audit, and the evaluation of the results of operations (see box).

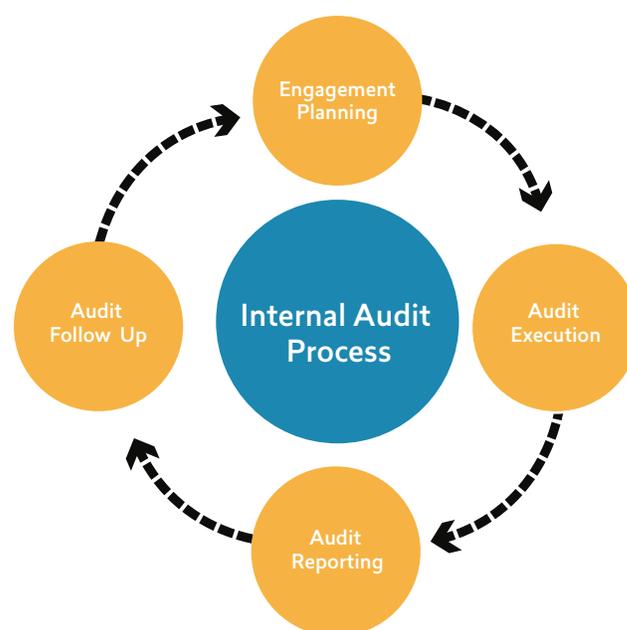
The audit process in the PGIAM involves four stages: engagement planning, execution, reporting, and audit follow-up (see Figure 2). The processes require the internal auditor to plan an audit engagement and implement the plan by using established standards or criteria. Subsequently, the auditor gathers evidence that support the given state of conditions

#### Three types of internal audit under the PGIAM:

- **Compliance Audit** – an evaluation of the degree of compliance with laws, regulations, managerial policies, and operating procedures in the government agency. A necessary first step to the two other types of audit, it includes an assessment of compliance with accountability measures, ethical standards, and contractual obligations;
- **Management Audit** – a separate evaluation of the effectiveness of internal controls adopted to determine whether they achieve the control objectives over a period of time or as of a specific date. It appraises the systems and processes, organizational and staffing structures, operations and management practices, records, reports and performance standards of the government agencies and units covered.
- **Operations Audit** – a separate evaluation of the outcome, output, process and input to determine whether government operations, programs and projects are effective, efficient, ethical and economical. In essence, it determines whether or not targets and expected results were achieved.

or substantiate the causes of such conditions. On these bases, the auditor analyses the findings of facts and subsequently formulates the recommendations that are communicated in the form of formal reports. Afterwards, the auditor monitors the status of actions undertaken relative to the approved audit recommendations.

Figure 2. Four Stages of the Internal Audit Process under PGIAM



Source: PGIAM

## Rolling Out the NGICS and the PGIAM

Initiatives undertaken by the government since 2010 has focused mostly on creating awareness and capacitating the bureaucracy as these are imperative in creating a solid foundation for the NGICS and the PGIAM to take off.

Specifically, the DBM spearheaded the roll out of the PGIAM and the NGICS, together with COA and Internal Audit Office of the Office of the President.

To operationalize the manuals, DBM led the capacity development of internal audit personnel in various national government agencies and the GOCCs. Together with the Development Academy of the Philippines, DBM designed the PGIAM Trainers' Training Manuals that consist of eight modules, pilot-tested the same, and rolled them out through capacity-building trainings. In 2011, DBM conducted two batches of trainers' training aimed at developing a corps of trainers in the government.

From 2012 to 2014, three phases of capacity-building trainings on NGICS or PGIAM were conducted, which were attended by personnel concerned from about 85 government agencies. Similarly, selected personnel from four government agencies—DOLE, DSWD, DBM, and DENR—attended an intensive training program through learning-by-doing. The DBM also rolled out the PGIAM on a whole of department basis in DepEd and DPWH; and on a limited basis in DOF, DOH, and DOJ.

Also, in 2012, senior officials from 57 agencies attended the briefings on Risk Management System - Principles and Guidelines as covered under ISO 31000:2009 and Risk Management – Risk Assessment Techniques based on ISO 31010:2009. The briefings were meant to instill among the officials a better understanding of the risks in their respective operations, putting them in a better position to come up with adequate controls that could mitigate the risks and enable them to achieve their respective organizational goals<sup>3</sup>.

In 2015, the PFM Certificate Program (PFMCP) was launched (*see Integrated PFM System*). Its foundation track, which is offered to all PFM professionals, includes a course on internal control. As of writing, the Technical Working Group on the PFM Institute (PFMI TWG) is currently developing a dedicated Internal Audit track for the PFMCP.

## WHAT REMAINS TO BE DONE?

### A Renewed Emphasis on Strengthening Internal Controls

Have the efforts to strengthen internal controls, particularly to establish internal audit service/internal audit unit (IAS/IAU), brought strategic value to the government?

According to the 2016 PEFA assessment, key indicators pertaining to the strength of internal controls have improved<sup>4</sup>. While the report cited the “extensive formal structure” of the government for internal control, “[e]xternal audit observations and audit qualifications are too numerous to be fully satisfied with the implementation of these controls, thus risking budget outcomes.” Moreover, an internal DBM report dated April 30, 2015 shows that 19 department-level offices, two constitutional offices, one legislative agency, one office in the judicial branch, and 52 GOCCs have IAS/IAU.<sup>5</sup>

From the time the NGICS and the PGIAM were promulgated in 2008 and 2012, respectively, until the end of 2015, the attempt to institutionalize internal controls and the corresponding internal audit functions has remained a challenge. At the moment, the attempt to enforce the provisions of the NGICS and the PGIAM has yet to result in substantial outputs that are beneficial to individual agencies and the government in general. As one could glean from the latest PEFA assessment, the presence of adverse or qualified audit findings by the COA betray the continued weakness of internal control systems in key government agencies.

Moving forward, several measures need to be undertaken or are currently being developed to actualize the potential of internal control systems and internal audit as crucial elements to good governance in the management of public funds.

First, the DBM is currently updating the generic manuals<sup>6</sup> on controls pertaining to three management systems: Human Resource Management System, Quality Management System, and Risk Management System. These initiatives fill in the dearth of specific guidelines on the establishment of these important management control systems in the agencies.

Second, most of the current initiatives concentrate on developing the capability of Internal Auditors and that they meet the necessary qualifications and competency requirements. The training programs that have been conducted must definitely be evaluated if only to find out whether the knowledge and skills gained translated into change in work behaviour and performance. As such, the PFMI TWG is currently applying the Kirkpatrick model<sup>7</sup> in evaluating the satisfaction of the PFMCP's participants, and it is currently developing an evaluation of their learning and behavior.

Third, the government should scale up its measurement of the effectiveness of internal control and internal audit. Monitoring efforts are currently focused on whether IAS/IAU are already established in the government agencies concerned. Eventually, the measurement should move into the extent of the accomplishments of internal control and internal audit units. For one, this requires the establishment of a baseline of the strength of the agencies' internal control systems, which would eventually become the basis for further assessments of how control deficiencies or gaps in the agencies have been addressed. Moreover, the success of the PGIAM can be measured by looking at the strategic plan of said units and the quality of their internal audit processes, including reports.

Over the long-term, the effectiveness of internal controls could be measured by the following: i) the amount of government assets safeguarded, and/or other measures of the judicious use of government funds and facilities in the delivery of public services; ii) the level of accuracy and reliability of accounting data; iii) the level of efficiency, effectiveness, and economy of operations of the government agencies; iv) the extent of compliance to laws and regulations of operating and support service systems; and v) the extent of adherence to policies promulgated by the management of the agencies. Meanwhile, the effectiveness of IAS/IAU could be measured against their respective performance targets as determined by the head of the agency during performance monitoring and evaluation.

Finally, the DBM should further strengthen its oversight functions on the establishment of internal controls and internal audit in the agencies. Already, the DBM has been playing this role by issuing guidelines and manuals on various aspects of the agencies' internal control systems, and by implementing capacity-building activities. Moreover, the DBM also recently made adjustments to its organizational structure with the hope of strengthening its oversight function: the establishment of the Public Expenditure Management Bureau under the Comptroller General Group, which is tasked to, among others, formulate measures on internal controls for the implementation of the government agencies to ensure the integrity, accuracy, completeness, and reliability of government financial and management systems.<sup>8</sup>

## NOTES

<sup>1</sup> Schick (1998) defines three types of expenditure controls: i) external control, wherein central agencies, such as Ministries of Finance, first provide authorization to line agencies and managers before they can spend public funds for specific items of expenditure; ii) internal control, where “those who spend public funds have first-instance responsibility for ensuring the legality and propriety of their actions,” although agency managers must still comply with “one-size-fits-all” standards for the management of personnel, assets, and other inputs; and iii) managerial accountability, which gives managers broad discretion on how to utilize resources in exchange for greater accountability for the results of the use of inputs.

<sup>2</sup> The earliest of such laws was the Internal Auditing Act of 1962 (RA 3456, as amended by RA. 4177), which provided for the creation, organization and operations of Internal Audit Service (IAS) as an independent staff unit in all national government agencies, GOCCs, and LGUs. The Integrated Reorganization Plan of 1972 (via P.D. No. 1) abolished the IAS and transferred their functions to the Financial Management Services of departments concerned.

<sup>3</sup> During the BAICS completed in September 2014, IAS identified the adopting of a policy on risk management as an opportunity for improvement, as none has been adopted yet.

<sup>4</sup> In particular: on payroll controls, from C+ (PI-18) in 2010 to B+ (PI-23) in 2016; on the effectiveness of internal controls on non-salary expenditures, from D+ (PI-20) to B+ (PI-25); and internal audit, from D+ (PI-21) to C+ (PI-26).

<sup>5</sup> Report from the Systems and Productivity Improvement Bureau of the DBM. August 25, 2015.

<sup>6</sup> While such manuals had been drafted in 2010, the DBM is currently revisiting and updating the same in coordination with relevant agencies concerned.

<sup>7</sup> The Kirkpatrick model is a global standard for evaluating the effectiveness of training in terms of four levels: a) reaction; b) learning; c) behaviour; and d) results (from [www.kirkpatrickpartners.com](http://www.kirkpatrickpartners.com))

<sup>8</sup> PEMB assumes this role in lieu of the SPIB, which has incubated internal control and internal audit policies and oversight in the DBM. It is also noteworthy that the SPIB led the implementation of the government-wide Rationalization Program (see *Insight from a Junior Leader on Rationalization*) to, among others, ensure that the Rationalization Plans of agencies include the organization of IAS/IAU in agencies concerned.