State Management Systems: The Case for Internal Controls

Joseph A. McHugh

This article contends that recent managerial improvements in the federal government can and should be replicated by the states. Although effective internal controls in federal agencies and programs had been mandated in 1950, little progress was made until the late seventies and early eighties, when Congress enacted several laws to strengthen federal financial management and the executive branch initiated a modernization program. This happy confluence of events brought significant improvements to federal management as a whole. Now it’s time for similar progress in state operations. State and even local administrators should adopt the best features of the federal model in order to reap significant savings. California, Tennessee, and Rhode Island have already done so; the author recommends that others follow their lead.

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Knowledgeable accountants, whether in industry or government, have always understood the importance of effective internal controls. In their battles against fraud, waste, and abuse, most modern societies have prescribed detailed accounting standards and principles for individuals, companies, and governments. In order to obtain further control over accounting procedures, they have created auditors to oversee compliance and stewardship. But until recently in the government of the United States, greater emphasis was placed on obtaining assets than on controlling their use. The function of planning and budgeting, that is, raising funds, was paramount. There was a proliferation of accounting systems, but they didn’t satisfy the informational needs of line managers. Nor did they contribute to managerial control; rather, they satisfied only legalistic concerns. Today a new focus has emerged, one that assigns great importance to strong internal controls in federal financial management as a means of ensuring the effective and efficient use of federal resources.¹ This article describes the progress made in federal financial management in the past decade and urges that each state adopt the successful aspects of the federal model.

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What Caused the Change?

To understand recent management improvements in the federal government, let us first look at the circumstances that invoked a renewed emphasis on controls within U.S. corporate boardrooms.

In the mid-seventies, the nation received a rude economic shock. Petroleum shortages, insufficient capital investments, labor strife, and inflation collectively led to a drastic decline in the economy. The American public learned that it was no longer the master of its own country's, let alone the world's, economic destiny. This period of travail was accompanied by a series of allegations that illegal acts such as bribery and extortion were routine goings-on in the nation's business deals, particularly in transactions involving the obtaining of foreign contracts. Economic discontinuities, governmental investigations, and a concerned citizenry combined to produce the Foreign Corrupt Practices Act (FCPA) of 1977. This act made it a criminal offense for any U.S. business to bribe any foreign official in order to obtain contracts. To ensure that such activities would be difficult to conceal, the Securities Exchange Act of 1934 was amended to require sufficient systems of internal-accounting controls. The FCPA also instituted criminal penalties both for businesses and for certified public accounting (CPA) firms in cases of willful violations of the FCPA.

At the same time that the media were reporting accusations against major corporations, the public was receiving a bitter education in economics. Until inflation exploded into double digits, the average citizen knew little of the concept. But as the ravages of inflation struck, each wage earner quickly learned about the erosion of purchasing power. At the national level, citizens learned that economists and accountants, politicians and policymakers, were neither omniscient nor omnipotent, as many had previously assumed.

Even the process leading to passage of the FCPA educated Congress, corporations, and citizens by virtue of the extended analyses and detailed media coverage. Moreover, given the threat of strong FCPA punitive sanctions, internal accounting controls became a real concern of corporate boards of directors. In 1982, the Federal Managers' Financial Integrity Act provided an even stronger stimulus for government managers to insist upon sound management systems encompassing both internal administrative and internal accounting controls.

The Evolution of Government Controls

The story of the sporadic and occasionally effective attempts to achieve progress in governmental financial management seldom stirs much excitement. Yet recent events have produced changes that are indeed dramatic, perhaps more so than any others in the realm of financial management since the founding of the republic. To put these changes in perspective, let's take a brief look at some important events in the history of efforts by the federal government to manage itself productively.

The first real progress in governmental financial management came 145 years after the republic was born, with the passage in 1920 of the Budget and Accounting Act. In one swoop, this act established the National Budget, the Bureau of the Budget, and the General Accounting Office (GAO). The next landmark was the Budget and Accounting Procedures Act of 1950, which assigned responsibility for establishing and maintaining adequate systems of internal control to the heads of federal agencies. The act also re-
quired (1) that agencies' accounting systems and systems of internal control conform to standards set forth by the Comptroller General of the United States, and (2) that all such systems be approved by him.5

However, neither the requirements for internal controls nor the provisions for accounting systems in the 1950 act were met with much attention or compliance. Despite ongoing pressure from the GAO, the lack of compliance with the Comptroller General's approval of accounting systems continued. By the 1970s, it had become a particular source of concern among accountants, and remains so today.6 With respect to internal control systems, Elmer B. Staats, who was U.S. Comptroller General from 1966 to 1981, explained the lack of progress this way:

The reason internal control systems are in a state of disrepair is that top management has devoted most of its concern and emphasis to delivering funds and services and that effective controls over tasks and functions which lead to the delivery of these funds and services [have] had a low priority. Because of top management's insufficient concern for internal controls, middle management reflects this same indifference.7

Pressures for Progress
The economic crisis of the mid-seventies created significant national ferment. But highly publicized revelations of fraud, waste, and abuse of government resources also fueled the anxiety. This confluence of conditions and events set the stage for a series of actions collectively dubbed the taxpayers' revolt. Two of the most important products of the revolt were Proposition 13 in California and Proposition 2½ in Massachusetts.8 These movements to limit or reduce the tax burden signaled to Congress, the executive branch, and bureaucrats at all levels of government an important change in the mood of the taxpayers. Indeed, this change represented a watershed in governmental financial management: citizens sent a message to their elected leaders that the search for solutions to public problems could no longer be financed by arbitrarily raising taxes!

Although Proposition 2½ and Proposition 13 were state-level initiatives, the citizens' message and the widespread attention it received were quickly transmitted to elected leaders in Washington, thus providing stimulus for reform in federal financial management. The Inspector General legislation of 1978, by focusing explicitly on the elimination of fraud, waste, and abuse with respect to federal resources, represented one of the first major efforts at reform after the period of turmoil in the mid-seventies. Although the Department of Defense had long had an Inspector General (IG), the office had only recently been created for the Department of Health, Education, and Welfare (now the Department of Health and Human Services) and for the Department of Energy. The 1978 legislation created Inspectors General in twelve more federal agencies. It combined the auditing and investigation forces under the authority of one responsible official, the IG, who would report to the agency head and to Congress. It also placed the responsibility for waging war on fraud, waste, and abuse specifically on the newly combined auditing and inspection forces. The legislatively mandated positions and duties provided the necessary organizational structure to ensure effective protection of government resources, but even the best auditing and inspection are carried out on an ex post basis. To achieve truly effective ex ante protection and productivity, responsibility for sound internal controls would have to be levied upon line managers. As we shall see, putting that part of the infrastructure in place would require four more years of lobbying and educational efforts by government financial managers.
Another Milestone

In 1978, the GAO estimated that the price of fraud in federal programs ranged between at least $12 and $15 billion annually; at the same time, the GAO acknowledged that the cost could be as high as $25 billion.9 In 1980, in his speech proposing the Financial Integrity Act, Sen. Thomas F. Eagleton (D-Mo.) quoted an estimate by the Inspector General of HEW that “between $6.3 billion and $7.4 billion was misspent annually at his department as a result of fraud, waste, and abuse—at a minimum.”10 Although he was addressing his remarks to the Senate, Eagleton was speaking for the nation.

This level of fraud, program abuse, and just plain waste in federal programs is unacceptable. We cannot permit the squandering of billions of dollars at this time of double-digit inflation and scarce budgetary resources. It fuels the fires of inflation. It robs Federal resources which otherwise might be available to meet legitimate—even pressing—needs. It promotes understandable public cynicism about all Federal programs, eroding support for these activities.11

Senator Eagleton’s efforts were matched by those of other legislators; for example, in 1980 Rep. Jack Brooks (D-Tex.) introduced H.R.8063, the Federal Managers’ Accountability Act. But these efforts did not bear fruit until September 1982, with the passage of P.L.97-255, the Federal Managers’ Financial Integrity Act (FMFIA). This act encompasses all managerial control systems, that is, it requires evaluation, assessment, and reporting of the status of both internal administrative controls and internal accounting controls. Thus, government managers are now responsible for the full scope of controls exerted over operational effectiveness and efficiency, a level of responsibility greater than that required in the corporate sector by the Foreign Corrupt Practices Act.12

In order to comply with the FMFIA, each federal agency must ensure that internal control systems are in place which meet the standards established by the GAO, in accordance with the procedures specified by the Office of Management and Budget (OMB), which was given responsibility for overseeing implementation of the act. As stated in the OMB’s Management of the United States Government, Fiscal Year 1987, these standards must meet three basic objectives: “Obligations and costs must comply with applicable law; funds, properties, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and revenues and expenditures are properly recorded and accounted for to maintain accountability over the assets.”13

Each year, agency heads must notify the president and Congress whether they have “reasonable assurance” that their systems measure up to the GAO standards and have been implemented in accordance with the OMB guidelines. These reporting requirements ensure that risk assessments and control evaluations do not get lost in the bureaucratic shuffle. If serious deficiencies exist, they must be listed in the report, along with a plan and timetable for correcting them. This latter requirement for follow-up constitutes another strengthening of managerial systems, since such plans and timetables can easily be audited.

Actions in the Executive Branch

While legislators were moving to improve federal management. President Reagan and managers in the executive branch tackled the size and complexity of the federal structure and its systems. To that end, in 1982, the president initiated a major management
improvement program. He named the program Reform '88, signifying his intention to amend, by the end of his second term of office, the archaic way in which the federal government was managed.

Reform '88 was based on four initiatives. The first and most immediate emphasis was placed on the President's Council on Integrity and Efficiency (PCIE), which was composed of the Inspectors General. The PCIE focused directly on eliminating government fraud, waste, and abuse, since these problems were deemed the most urgent. The results of the council's activities will be addressed below.

A second group, the President's Council on Management Improvement (PCMI), was comprised of key management officials within the major federal agencies. The group's mission was and still is to focus on the degree of productivity with which federal resources are used. Among the PCMI's early accomplishments was a comprehensive system of cash-flow management to ensure the effectiveness with which the government's $10 trillion annual cash flow is administered. Another project was the establishment of a "comprehensive program to manage better the $257 billion Federal loan portfolio—which has $24 billion in delinquent accounts." Other projects related to the reduction of federal personnel, the simplification of forms, and a substantial decrease in the amount of paperwork involved in the day-to-day work of federal agencies. The PCMI is also working on the simplification of personnel and payroll systems.

A third initiative was intended to bring businesslike procedures to the federal establishment. The President's Private Sector Survey on Cost Control (PPSSCC) was more popularly referred to as the Grace Commission after its chairman, J. Peter Grace. Composed of a number of task forces drawn from leaders in business, the commission produced 2,160 recommendations on how federal processes might be brought into line with modern business practices. Such recommendations were said to "have the potential of approximately $69 billion in savings through 1991."

The last of the major initiatives was the President's Productivity Program. In order to ensure that the federal sector, like the private sector, would become more productive, "the President, in a July 31, 1985, message to Congress, announced a new Governmentwide program to improve productivity 20% by 1991 in selected high priority functions."

Departments and agencies have been challenged to find ways to improve their productivity by at least 20 percent from a 1985 fiscal year baseline. Over 100 success stories are described in the PCMI publication Improving Federal Productivity: An Inventory of Agency Examples.

Internal Controls Are Working

How do we know that the PCIE, the PCMI, the efforts of the Inspectors General, and the internal control programs are working? The FY1987 management report of the president indicates that "in the 4½ years since the Council [PCIE] was created, the Inspectors General have reported over $63 billion in improved use of funds ... 14,291 successful civil and criminal prosecutions ... and 14,146 administrative sanctions or agency actions against Federal employees, contractors and grantees who defrauded or abused Federal programs or systems."

But what about some tangible examples? In the first round of reports, the Department of Commerce has noted improvements in program delivery and in management controls. For example, export licenses are processed faster and overhead costs have been reduced; processing time for patents has also been reduced, as have payroll costs.
More important, weaknesses in the security of files, property, and automated data processing have been identified. The Department of Education has reported weaknesses in the monitoring of grants and contracts but has also created plans and schedules for correcting the defects, as required by the FMFIA. Details of all improvements are contained in the president’s management messages, which accompany his annual budget submissions to Congress. These messages include many examples of significant efforts and accomplishments across the spectrum of federal programs and agencies. The results are truly impressive, and many of these achievements could be replicated at the state and local levels.

We can obtain some insight into the continued accomplishments of the IGs by examining trends reported by Richard P. Kusserow, Inspector General of the Department of Health and Human Services, in his semiannual report on the period April 1, 1986, to September 30, 1986:

This report summarizes Department of Health and Human Services (HHS), Office of Inspector General (OIG) major activities, initiatives and results for the 6-month period ending September 30, 1986. The OIG has oversight responsibilities for some 54 million beneficiaries and a 1986 Department Budget of $334 billion. The goal of the OIG is to promote the economy, efficiency and effectiveness of HHS programs and reduce the incidence of fraud, waste and abuse through inspections, audits and investigations. The OIG concluded and processed over 3,174 audits and inspections, and 2,868 investigations during the year. About 60 percent of OIG effort was devoted to Medicare and Social Security programs that are financed by the trust funds.

Speaking before the Boston chapter of the Association of Government Accountants in April 1984, Mr. Kusserow pointed out that the HHS budget represented 38 percent of the national budget. He also spoke of looking forward to the day when an effective network of preventive controls would be in place, thereby leading to a lessened requirement for after-the-fact detection. For the six-year trends between 1981 and 1986 in prosecutions, sanctions, and savings in the Department of Health and Human Services, see figure 1.

**Figure 1**

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What Turned the Tide?

The tools of internal control were created in the 1950s but weren’t utilized until the 1970s and 1980s. What caused the turnaround? The taxpayers’ revolt certainly captured the imagination of the public and provided a spark. But even more important forces were at work. Inflation became a powerful educator and motivator. “Doing more with less” became more than a pious platitude to be mouthed at annual financial management conferences; it became a reality. Once the spigot of additional funding through increased taxes had been turned off, only two other options were available to government managers. One was to lessen output, that is, reduce the quantity and/or quality of products and services. But the electorate made its feelings known; such an
alternative was unacceptable.

With inputs (taxes) limited and outputs (service levels) kept constant, only one other option remained. Greater productivity could be achieved only by stemming the fraud, waste, and abuse that were known to exist. Thus the impetus for effective internal controls came from an educated and irate public, which convinced its elected officials and thence the bureaucracy that continued ineffective management of resources was intolerable. The benefits of that involvement on the part of the electorate are now being reaped by the taxpayer at the federal level and, to a lesser extent, at state and local levels.

What Next?

The forces that brought effective internal controls and productive management practices to the federal government must now be focused on state and local governments. The opportunities for improved productivity at those levels are even greater, because the lessons learned and successes achieved at the federal level can be used as models.

But it must be acknowledged that the accomplishments cited above did not come cheaply. The federal government mandated a risk assessment and an internal control evaluation of all elements of the federal organizational structure. An October 1985 study by the President’s Council on Management Improvement, entitled Streamlining Internal Control Processes and Strengthening Management Controls with Less Effort, estimated that “implementation in FY 84 required 1.2 million staff days and 1.6 million original pages . . . translating into an annual direct salary cost of $240 million . . . spent primarily on evaluating controls.”

Fortunately, the same effort need not be so costly at state and local levels, thanks to both the PCMI study just cited and a private-citizens’ initiative known as Responsibility Systems. The PCMI study, as its name suggests, provides recommendations from six major agencies for easier ways of carrying out a risk assessment and evaluation of internal controls. In the private sector, Responsibility Systems may be one of the most exciting developments in the field of management-control theory. The methodology was devised by Charles Dempsey, former Inspector General of Housing and Urban Development (HUD); Elsa Porter, a former assistant secretary of commerce for administration; and Richard Willett, of Grant Thornton, CPAs—in response to cries from federal managers that internal control reviews had created yet another layer of bureaucracy.

The Responsibility Systems methodology is an educational and evaluative program in which top-level managers and trainers assess their managerial responsibilities and relationships. The then-trained cadre spreads the methodology to others, until an entire organization has evaluated its hierarchy of authority and responsibilities as well as its risks and relationships. The result is a very effective and inexpensive controls assessment that is in keeping with the requirements of federal and state Integrity Acts that have already been passed—with a key difference, however, provided by Responsibility Systems: an emphasis upon line managers assessing their own operations, leading to decreased reliance on outside auditors or evaluators. The Responsibility Systems approach is appropriate and effective for any organization—federal, state, local or corporate.

Federal managers have learned much about effective managerial control as a result of the FMFIA, and, more important, they have developed new methods of evaluation. But no great impetus has developed at the state or local level to construct similar approaches
for enhancing productivity. Perhaps the primary reason for this inertia is that the federal story has not yet been broadcast to the public. Fraud, waste, and abuse make more attractive headlines than the story of a streamlined management system. Many managers, fearing intrusion into their bailiwick, prefer the status quo; others firmly believe that controls are strictly an accountant’s or an auditor’s concern. It would appear, then, that an informed electorate must be created if the federal model is to be successfully adopted, and forward-thinking public administrators will have to supply the stimulus for such improvement.

A Head Start

Successful models of state-level Integrity Acts already exist. California, Tennessee, and Rhode Island have passed legislation that (1) mandates managerial responsibility for effective control systems, (2) insists on continuous evaluation of both internal administrative and internal accounting controls, and (3) ensures that findings become public information. Although definitive results are not yet available, the initial effects from state legislation appear promising. For example, in California, legislatively mandated reviews resulted in 604 recommendations to state managers. Of this number, 142 related specifically to the protection of cash. The next highest category, property, received 85 recommendations; revolving funds, 83; and accounts receivable, 68. An official from California summed up the state’s experience thus far with the Financial Integrity and State Managers’ Accountability Act, passed there in 1983: “The major advantages to date resulting from passage of the act have been in the area of manager awareness and in the fact that the implementation of corrective plans is now backed up by statutes.”

In other words, whereas previously such findings as the 604 recommendations could have been ignored, they no longer can be. Follow-up is now mandated by law. More important, in California all managers, not just financial managers, are now responsible for reviewing their organizations and operations in order to ensure that susceptibility to fraud, waste, and abuse is identified and dealt with.

So wherever Integrity Acts have been passed, management’s inherent responsibility to control has been explicitly and legislatively joined to its responsibilities to plan and direct. In any organization—federal, state, local, or corporate—that’s a powerful force for effective and efficient management.

New England’s Needs

Rhode Island’s legislation provides a good model for other New England states. Installing strong management controls is imperative for all the states of the New England region. For example, although Massachusetts is currently enjoying a favorable economic climate, it need not look too far back to remember darker days, when the costs of fuel, heating, and air conditioning were exorbitant.

The Massachusetts cost of living and cost of housing are now among the highest in the nation. A large component of such costs are the taxes needed to finance state and local governments. Thus, any improvement in public management that will constrain or reduce taxes can help offset the other costs intrinsic to residing in the Frost Belt. Such benefits would be equally worthwhile for individual citizens and businesses, whether in Massachusetts or any other state in the region. Every New England state is faced with
the same kinds of demands for service in spite of scarce resources.

Beyond the pragmatic economic benefits, state and municipal managers, administrators and legislators, all have a duty to promote productivity. Given these responsibilities and the demonstrated value derived from enhanced managerial control, what needs to be done?

Recommended Action

Education holds the key! An informed citizenry wrought great change at the federal level in a relatively short period of time, once the legislators were convinced that business could not continue as usual. The same startling change in values can be achieved in states and municipalities if attention is focused on those arenas.

Informed public administrators, particularly those in financial management and auditing, should devise a program to inform the public and persuade legislators to follow the lead of Rhode Island, California, and Tennessee by promoting adaptation of the Federal Managers' Financial Integrity Act. Formal attempts to reduce fraud, waste, and abuse, and to consciously and deliberately promote improved management, could come from establishing councils analogous to the PCIE and the PCMI. Similarly, state auditors should join with state IGs, attorneys general, comptrollers, directors of administration and finance, and legislative post-auditors to create an appropriate infrastructure.

Professional organizations devoted to the pursuit of sound public management should promote the concept and lobby for state-level Integrity Acts where none exist. Through professional appearances, publications, and forums, academics specializing in public management and public financial management could provide a valuable service by educating the citizenry and public officials about the critical need for such legislation. The New England Government Financial Managers' Roundtable will sponsor speakers on the topic in the fall of 1987.27

The task of improving internal controls and enhancing public management will not become an exciting priority overnight. But the effort must be made now, while economic conditions are favorable. If the states learn from the federal experience, we can bring about the necessary improvements rapidly, before another round of economic disarray and an unhappy public force them upon us.  

Notes

1. Reform '88 was the name given by President Reagan to his comprehensive program for the protection and productive use of federal resources. Descriptions of the program and its accomplishments can be found in Executive Office of the President, Office of Management and Budget, Management of the United States Government, Fiscal Year 1986 and Management of the United States Government, Fiscal Year 1987 (Washington, D.C.: Government Printing Office).

2. The Foreign Corrupt Practices Act takes its name from Sections 103 and 104 of the act. These "anti-bribery" provisions prohibit domestic businesses from engaging in certain "foreign" corrupt practices. Observers have deplored the use of the word foreign here and in the name of the act, since it implies a superior U.S. morality vis-à-vis other nations.

3. The "accounting provisions" of the FCPA were added to the Securities Exchange Act of 1934 as Section 13(b)(2). These are the provisions requiring adequate systems of internal-accounting controls.
4. The Federal Managers' Financial Integrity Act of 1982 required risk assessments of all management systems and a review of all controls, both administrative and accounting.

5. The Budget and Accounting Procedures Act of 1950 (64 STAT.832,834). The short title is the Accounting and Auditing Act of 1950.

6. The frustration stems from the fact that as recently as 1980, only 62 percent of the accounting systems had met the Comptroller General's standards. Thus, many ad hoc systems flourished without oversight or control. Many of these were substandard or could not interact with other systems. In a position statement by the Association of Government Accountants (AGA) supporting the IG legislation, Art Schoenhaut, president of the AGA, said that "more than half of the Federal budget is accounted for by the 73 unapproved systems of the Department of Defense and the Department of Health and Human Resources." See the Government Accountants Journal 29, no. 3 (Fall 1980): 34.


8. Proposition 13 in California, passed in 1978, was the first initiative to limit the levy of additional state taxes. Proposition 2½, passed in 1981, limited the local property taxes in Massachusetts and effectively capped operational funding in cities and towns. Both pieces of legislation generated controversy as states, cities, and municipalities struggled to cut operating budgets.


10. Ibid.

11. Ibid.

12. By mandating administrative controls, the Federal Managers' Financial Integrity Act effectively legislated good management and stewardship over federal resources, and thus went beyond merely requiring controls over the accounting for, and reporting on the use of, assets.


15. Ibid., 1.

16. Ibid., 3.

17. Ibid., 10–11.

18. Ibid., 12.

19. Ibid., 7.

20. Ibid., 126–32.


23. Ibid.


25. This legislation, in California, is the Financial Integrity and State Managers' Accountability Act of 1983; in Tennessee, the Financial Integrity Act of 1983; and in Rhode Island, the Financial Integrity and Accountability Act of 1986.

27. The New England Government Financial Managers’ Roundtable is sponsored by the John W. McCormack Institute of Public Affairs and the College of Management of the University of Massachusetts at Boston. The roundtable provides a forum for individuals who are dedicated to the improvement of government financial management at all levels. More information may be obtained from the John W. McCormack Institute of Public Affairs, University of Massachusetts at Boston, Harbor Campus, Boston, MA 02125-3393 (617–929–7275).