



INTERNAL CONTROL NEWS

The purpose of this quarterly newsletter is to provide departments with articles on good business practices, internal controls, and responsibilities. Through articles intended to promote educational and professional development opportunities for employees, this newsletter seeks to raise awareness across state government on the importance of internal controls. We hope that by providing this array of information, we can keep you informed of internal control related activities, and help you implement and maintain effective controls in your areas of operation.

Self-Assessment is Back

The 2nd annual *Self-Assessment of Internal Control* questionnaire will be distributed to all departments in April 2006. Control self-assessment (CSA) is a process through which internal control effectiveness is examined and assessed. CSA is conducted within a structured environment, is thoroughly documented, and the process is repetitive as an incentive for continuous improvement. CSA permits management and others responsible for a business function to:

- Participate in the assessment of internal control.
- Evaluate risk.
- Assess the likelihood of achieving business objectives
- Develop actions plans to address identified weaknesses.

Internal Control Standards

On February 16th, Secretary of Administration Mike Smith issued *Internal Control Standards: A Guide for Managers* to all agency and department heads and business managers. With the release of this document the Agency of Administration has further demonstrated its commitment, and expectation of all government managers, to strengthen internal controls throughout Vermont State Government. As Secretary Smith stated in his transmittal letter, effective internal controls are key ingredients in improving business processes, minimizing risks and operational breakdowns, and ultimately ensuring that our programs are successful and achieve their intended goals. This guide can also be located on the Department of Finance and Management's website under a new "Internal Controls" link at:

http://finance.state.vt.us/internal_publications.htm

Legislative Testimony

On January 25th, Steve Vantine of the Department of Finance and Management was requested to testify before the House Appropriations Committee on the Agency of Administration's internal controls initiative. Steve testified that through a process of education, awareness, and accountability the Administration is working collaboratively with departments to seek improvements in the three primary objectives of internal control: 1) Effective and efficient operations, 2) Reliable financial reporting, and 3) Compliance with applicable laws and regulations. Steve also spoke about some of the

accomplishments to date and on-going activities such as the self-assessment questionnaire, operational/compliance reviews, internal control standards, and the best practices series. In their response, the committee was encouraged and supportive of the State's efforts to improve internal controls and requested copies of some key documents for their review.

CAFR Completed

Completion of the fiscal year 2005 audit permitted issuance of the State's Comprehensive Annual Financial Report (CAFR) in December 2005, meeting the statutory issuance date of December 31st for the first time in recent years. The CAFR is required by state law and conforms to generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). It is the official record of the State's financial position at June 30, 2005. The CAFR is sent to the Governor and other key executives, the legislature, the State's bond rating agencies, and is available to all interested parties through the Department of Finance and Management's website. We wish to thank all those who helped in the year-end closing process, which enabled us to finalize the State's financial records. With your help, we again received an unqualified ("clean") audit opinion from the State Auditor. The State Auditor's annual report for FY 2005, including the federal Single Audit, is expected to be issued within the next month.

The Risk of Unattended PCs

Users often complain about having to log on and off their workstations, or worse yet being automatically timed-out of a system. But a more thorough understanding of the potential risks posed by an unattended workstation can alleviate some of this contempt for what is often perceived as a 'waste-of-time'. Departments are responsible for protecting their systems and personnel from external and **internal** security threats. The threats posed by unattended PCs are significant and range from the capability to access confidential or sensitive data, to executing unauthorized transactions, to sending e-mail disguised as another employee, to improper on-line activity. Without effective computer security it is difficult to identify and discipline employees for inappropriate activity when the excuse of "someone else must have used my PC" can't be disproved. Therefore, through the use of login IDs, passwords, and automatic time-outs, departments are taking the necessary precautions to mitigate these risks.

Data Analysis Using Benford's Law

Did you know there is nearly a 50% chance that the amount of the next invoice you pay will begin with either a "1" or a "2"? Randomly pull any accounts payable voucher and most people would intuitively assume there is an **equal chance** the first digit of the payment could be any number from 1 through 9. But according to Benford's Law there is a 30.1% chance the first digit will be a "1", a 17.6% chance it will be a "2", with decreasing frequency for all successive numbers.

- ❑ **Benford's Law** states that in lists of numbers from many real-life sources of data, the leading digit "1" occurs much more often than others (namely about 30% of the time). Furthermore, the larger the digit, the less likely it is to occur as the leading digit of a number.

Dr. Frank Benford, a General Electric physicist working in the 1930s, proved his theory through analysis of a wide array of datasets including areas of rivers, baseball statistics, populations of towns, stock quotations, numbers on the front page of the NY Times, and the half-lives of molecular compounds. All of these seemingly dissimilar datasets followed the predicted probability pattern with the number "1" turning up as the first-digit about 30% of the time. A simple explanation is that for a number to increase from a first-digit of 1 to 2, it has to double or have a 100% growth. However, to increase from 8 to 9 only requires a 12.5% increase...thus higher numbers tend to turn over much more frequently than lower numbers...and conversely lower numbers "stay around longer", thereby increasing their frequency.

Benford's law does not work well with small sample sizes, nor does it work for numbers controlled to a specific value (e.g. IRA contributions), or assigned numbers (e.g. bank account numbers or zip codes), or for truly random numbers (i.e. you can't use it to improve your chances of winning the lottery). But it does hold true in a surprising number of situations...financial data, demographic data, geographic data, and scientific data all follow Benford's expected first-digit probability. Benford's law demonstrates that naturally occurring data can be remarkably resistant to complete randomness. However, the fit of Benford's law is not infallible...deviations may occur for innocent reasons. For example, in a department which processes a substantial number of **\$20** medical co-payments on behalf of its clients, the first-digit frequency of the number "2" may likely be skewed in an examination of that department's disbursements data.

Aside from *stimulating* party conversation, how might this information be practically applied? The Internal Revenue Service, State Agencies, CPAs and auditors are using Benford's law and other digital analysis to spot frauds, embezzlers, tax cheats, sloppy accountants, and even computer glitches. Development of software based on Benford's law provides a powerful and relatively simple tool for detecting potentially fraudulent activity, processing inefficiencies, or data manipulations. Benford's law can be used to detect data anomalies, but by itself it proves nothing beyond that the data does not conform to expected mathematical probabilities...it does not reveal causation, intention, or reason for the deviation. However, knowledge of Benford's law, coupled with professional judgment, can provide CPAs and auditors with an effective tool to identify data that falls outside expected patterns and worthy of further investigation.

What are Operational Reviews?

The purpose of an operational (or compliance) review is to improve the State's financial operations. Operational reviews focus on the effectiveness and efficiency of a function or process. They address such areas of concern as:

- ✓ "Are objectives being met?"
- ✓ "Are assets being appropriately safeguarded?"
- ✓ "Are potential risks being minimized?"
- ✓ "Is there compliance with applicable statutes, bulletins, or procedures?"

During the past year, with the assistance and cooperation of the departments, we performed reviews of the following subjects:

- Timely Vendor Payments
- Self-Assessment Questionnaire Responses
- Cash Receipts & Deposits
- Purchase Orders and Contracts
- Petty/Imprest Cash Accounts (*on-going*).

(Note: These operational reviews are not audits, nor do they take the place of the audit function of the State Auditor's Office.)

Important Dates

Early April	Self-Assessment of Internal Control questionnaire distributed to departments.
Mid-April	FY 2006 VISION Year End Closing Instructions issued.
April 21 st	Expected deadline for completion of self-assessment questionnaire.
July 1 st	Effective date for Bulletin 5.5 - Policy for Issuing and Monitoring Grants of State Funds .

Importance of Written Procedures

Written procedures provide departments with a valuable way to communicate to employees on "how" (and "why") to handle a particular process. This promotes the likelihood of processing transactions consistently, timely, and accurately. Written procedures also help employees on how to identify or address unauthorized, incomplete, or erroneous transactions. In summary, documenting procedures supports proper accounting, minimizes errors in processing and recording, and provides for business continuity during periods of change.

Best Practices Series

On March 13th, the Department of Finance and Management issued **Best Practices for Cash Receipts and Deposits**, the first in a series of documents to be released over the coming months. Best practices represent proven methodologies for consistently and effectively achieving a business objective. We encourage departments to use these **best practices** to evaluate the adequacy of their own processes and as a resource for implementing business process improvements in their organizations. This document can be accessed at the Department of Finance and Management's website at:

http://finance.state.vt.us/internal_publications.htm