Risk and Control in Local Governments:
What Governments Should Learn from the Corporate Accounting Scandals
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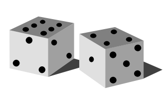
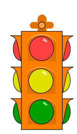
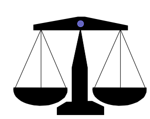
What's Happening in the Private Sector
As corporate accounting scandals such as Enron, Worldcom and Tyco rocked the U.S. economy over the last few years, it may have been easy for local government officials to smugly note that these scandals were caused by the pressure on corporations to maximize shareholder returns.

Despite the differences between publicly held corporations and local governments, there are also many similarities. Both publicly held corporations and local governments are complex, multi-activity, accountable to non-management stakeholders, regulated, watched closely by the media, and managed by a governing board. Accordingly, there are many lessons local governments can learn from the emerging "best practices" being implemented by corporations as a result of the recent corporate scandals. For example, new laws put in place as a result of the scandals require management of publicly held corporations to assess the effectiveness of internal controls and report on it in the annual financial report. The outside auditors must evaluate the internal controls. There was widespread concern related to this requirement to assess internal controls as corporate boards of directors and senior management realized that they did not have a good understanding of their internal controls, and did not have a standard method to implement, assess and revise controls.

An Overview of Risk and Control
How does *your* government establish internal controls and assess their effectiveness? Even though Sarbox is not applicable to local governments, it is critical that this question can be answered by the elected board and senior management. The first step is to understand the relationship between objectives, risks and controls. That relationship is summarized as:

$$\textbf{RISK}_{\text{(objective)}} - \textbf{CONTROL} = \textbf{EXPOSURE}$$

Governments set objectives. For each objective there are risks. The risks to which a government is exposed changes as its objectives change. If your objective is to climb Mount Everest you will face risks related to weather, equipment failure, physical health/conditioning and food supplies. But if your objective is to scuba dive, you will face risks related to oxygen supply, shark attack and air pressure. Similarly, a government's objective to provide day care services will expose it to far different risks than its objective to improve the condition of streets.

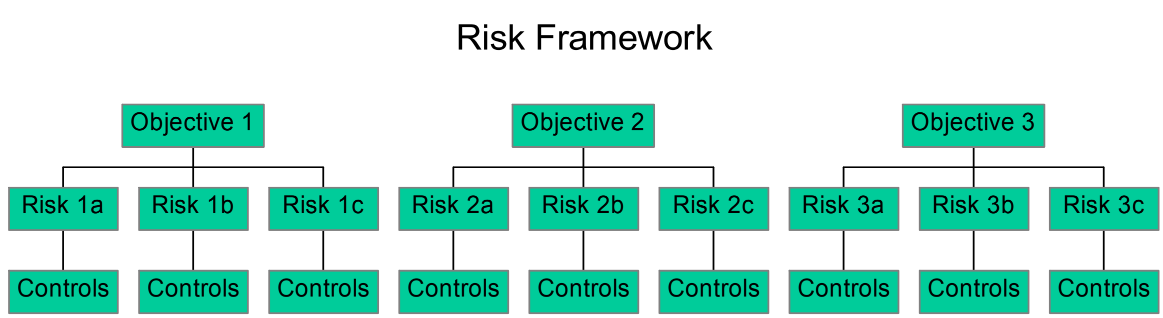
Governments put controls in place to maximize the probability of meeting their objectives. Using this definition, in the context of a government, “controls” is another word for “procedures”. Therefore everything that every employee does every day meets the definition of a control. For example, if your objective is to drive to work on time, one of your risks might be oversleeping. Some of the controls you might put in place are using the snooze button on your alarm clock, using two alarm clocks, asking your spouse to awaken you, having a contingency plan to skip breakfast to make up time, etc.

In the formula above, risk minus control equals exposure. So if the government implements too few controls related to a risk, it remains exposed to the risk. If the only control you use to assure not oversleeping is to use two alarm clocks, you must assess the risk of sleeping through both, and then add more controls if necessary. Alternatively, if a government implements so many controls or such stringent controls beyond those needed to reduce the exposure to an acceptable level, then it hinders its efficiency (i.e. creates “red tape”).For example, a government that issues both a cash register receipt and a manual receipt upon collection of a fee may have more controls than is efficient.

What Local Governments Should Do

Similarly to publicly held corporations, local governments should perform risk and control assessments so that the elected board and senior management can assure the taxpayers that internal controls are adequate. Regardless of the risk and control assessment method employed, the risks related to each of the government’s major objectives should be identified and prioritized. Then each risk should be compared to the related controls that are already in place to determine whether the resulting exposure is acceptable. These steps can be accomplished in brainstorming sessions among the government’s most knowledgeable employee experts.

The government should document its objectives, risks and controls in a logical framework, such as:



Each risk should then be prioritized based on the group’s expectations of its relative probability of occurrence and severity as shown in Table 1.

After comparing each risk to its related controls, the government must conclude whether the resulting risk exposure is at an unacceptable level. If so, the government can:

- Avoid – change its objective so it is not exposed to this risk
- Control – enhance controls so the resulting exposure is managed to an acceptable level
- Transfer – transfer the risk to another party through contract, ordinance or insurance
- Accept – revise its tolerance for risk and conclude that the resulting exposure is acceptable

In conclusion, for a government to be able to conclude on the adequacy of its internal controls, it must:

1. Identify the risks related to each of its major objectives
2. Prioritize each of the risks based on probability and severity
3. Identify the related controls that are already in place related to each risk
4. Assess the adequacy of the controls
5. Accept, avoid, control or transfer the risk
6. Put a process in place to continually monitor the effectiveness of controls and to identify new risks as they emerge.

Table 1 - Severity / Probability Chart