State of Alaska Base Internal Control Objectives

Purpose – to use with the workbook ***Internal Control Annual Checklist*** document a base line for Statewide Internal Control objectives and provide applicable information from the Green Book and ***Alaska Administrative Manual (AAM 05) Internal Controls***. State Agencies should use this document as a starting point when designing, assessing, and monitoring their Internal Control System. Documentation of this step-by-step process is a necessary part of an effective internal control system.

Scope – the State of Alaska has adopted the *'Standards for Internal Control in the Federal Government',* known as the Green Book, which sets internal control standards for the Federal Government and can be adopted by State and other Governmental entities. The Green adapts the Committee of Sponsoring Organization (COSO) framework 2013 updates for Government Environments.

Background –

The concept of **accountability** for use of public resources and government authority is key to our nation's governing processes. Management and officials entrusted with public resources are responsible for carrying out public functions and providing service to the public effectively, efficiently, economically, and ethically within the context of the statutory boundaries of the specific government program.

Internal Control is a process used by management to help an entity achieve accountability and its objectives. All objectives and subobjectives can be broadly classified into one or more of these 3 categories:

- Run its operations efficiently and effectively
- Report reliable information about its operations
- Comply with applicable laws and regulations

Reporting objectives and subobjectives are further categorized as being either internal or external and financial or nonfinancial.

The standards in the Green Book are organized by five components of internal controls, seventeen related principles, and additional underlying attributes which are listed in the Green Book and AAM 05 Internal Controls.

Base Line Statewide Control Objectives:

The basic Statewide objectives all State Agency's must uphold are:

- Promote and demonstrate integrity and ethical behavior at all levels.
- Operate efficiently and effectively, minimizing the risk of fraud, waste, or abuse.
- Safeguard assets.

- Maintain readily available and reliable financial data in accordance with professional standards, for both internal and external reporting.
- Maintain readily available and reliable non-financial data in accordance with appropriate standards, for both internal and external reporting.
- Comply with all State requirements, including but not limited to Alaska Statutes (AS), Alaska Administrative Code (AAC), Alaska Administrative Manual (AAM), Alaska Procurement Code, Alaska OMB rules, DOA Human Resource recruitment and payroll rules, OIT rules.
- Comply with all applicable Federal requirements.
- Comply with all other applicable requirements as identified and documented at all levels Statewide.
- Built-in proper segregation of duties into the State of Alaska Organizational Structure.
- Delegation of Authority Forms limited to only what is necessary for specific positions and follows proper segregation of duties.

Each State Agency must create their own subobjectives based on its mission, regulatory environment, strategic plan, and entity size. This includes identifying all applicable State, Federal, and other requirements program by program; designing and implementing internal controls to give reasonable assurance of compliance with each.

Control Environment:

The Control Environment is the foundation for an internal control system. It provides the discipline and structure, which affect the overall quality of internal controls.

Oversight Agencies and Agency Management should ensure the following-

- Strong commitment to promoting and demonstrating integrity and ethical behavior.
- Create a strong '**tone at the top'** and '**tone in the middle'** encompassing the various layers of management, by example through directives, attitudes, and behavior.
- Built-in checks and balances between oversight agencies and agency management to hold each other accountable and ensure Standards of Conduct are adhered to.
- Leadership at all levels frequently communicates expectations concerning integrity and ethical values.
- As part of all employee's annual evaluations, management evaluates adherence to integrity and ethical values.
- Agencies must recruit, develop, and retain competent personnel.
- Expectations of **competence** should be defined for each role which personnel need to possess and maintain to allow them to accomplish their assigned responsibilities, as well as understand the importance of internal control.
- **Competence** is the qualification to carry out assigned responsibilities and requires relevant knowledge, skills, and abilities, which are gained largely from professional experience, training, and certifications.
- **Segregation of duties** helps prevent fraud, waste, and abuse in the entity by considering the need to separate **authority, custody,** and **accounting** in the Organizational Structure.

Risk Assessment:

Having established an effective control environment, Oversight bodies and Agency Management assess the risks from internal and external sources facing the entity as it seeks to achieve its objectives. Objectives/subobjective must be defined in specific terms so they are understood at all levels of the entity, clearly defining what is to be achieved, who is to achieve it, how it will be achieved, and the time frames for achievement.

Agency Management sets internal expectations and requirement through the established standards of conduct, oversight structure, organizational structure, and expectations of competence as part of the control environment.

1. Make a list/review current list to ensure includes all external requirements and internal expectations by function group or program.
2. Set a **Risk Tolerance** for each objective/subobjective. Risk Tolerance should be defined in specific measurable terms and often measured in the same terms as the performance measures for the defined objective:
   - **Operations Objectives** – level of variation in performance in relation to risk.
   - **Nonfinancial reporting** objectives – level of precision and accuracy suitable for user needs, involving both qualitative and quantitative considerations to meet the needs of the nonfinancial report user.
   - **Financial Reporting objectives** – judgement about materiality are made in light of surrounding circumstances, involving both qualitative and quantitative considerations, and are affected by the needs of the financial report users and size or nature of a misstatement.
   - **Compliance objectives** – concept of risk tolerance does not apply. An entity is either compliant or not compliant.

   Note - If Risk Tolerance defined for an objective/subobjective are not consistent with external requirements or internal expectations, management revises the risk tolerance to achieve consistency.

3. Identify risks throughout the entity to provide a basis for analyzing risks. Such as:
   a. Agency's past experience – including past audit or review findings
   b. Staffing levels and quality
   c. Statutory framework
   d. Significant and complexity of activities related to the agency or specific program's mission
   e. Use of technology and length of time
   f. Political pressures and public awareness
4. Analyze identified risks, individually or group of related risks, to estimate their significance:
   a. Magnitude of impact
   b. Likelihood of occurrence

    c. Nature of the risk

5. Design responses to the analyzed risks so that risks are within the acceptable defined risk tolerance for defined objectives.
    a. **Acceptance** – No action is taken to respond to the risk based on the insignificance of the risk.
    b. **Avoidance** – Action is taken to stop the operational process or the part of the operational process causing the risk.
    c. **Reduction** – Action is taken to reduce the likelihood or magnitude of the risk.
    d. **Sharing** – Action is taken to transfer or share risks across the entity or with external parties, such as insuring against losses.
6. Consider potential for fraud when identifying, analyzing, and responding to risks.
    a. **Fraudulent financial reporting** – intentional misstatements or omissions of amounts or disclosures in financial statements to deceive users.
    b. **Misappropriation of assets** – theft of an entity's asset. This could include property, embezzlement of receipts, or fraudulent payments.
    c. Corruption – bribery or other illegal acts.
7. Consider if the **fraud risk factors** are present when identifying fraud risk-
    a. **Incentive/pressure** – management or other personnel have an incentive or are under pressure, which provides motive to commit fraud.
    b. **Opportunity** – Circumstances exists, such as the absence of controls, ineffective controls, or the ability of management to override controls, that provide an opportunity to commit fraud.
    c. **Attitude/rationalization** – individuals involved are able to rationalize committing fraud. Some individuals possess an attitude, character, or ethical value that allow them to knowingly and intentionally commit a dishonest act.
8. Consider potential for other misconduct that can occur such as waste and abuse.
    a. **Waste** – act of using or expending resources carelessly, extravagantly, or to no purpose.
    b. **Abuse** – behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary given the facts and circumstance. This includes the misuse of authority or position for personal gain or for the benefit of another.
9. Analyze and respond to identified fraud risk and risk of other misconduct to ensure they are effectively mitigated by using control activities.
10. Identify, analyze, and respond to changes that could significantly impact the entity's internal control system. This process is similar to, if not part of, the entity's regular risk assessment as noted above. However, change is discussed separately because it is critical to an effective internal control system and can often be overlooked or inadequately addressed in the normal course of operations.

Oversight bodies oversees management's assessments of fraud risk and the risk of management override of controls so that they are appropriate.

Control Activities:

Control actives are the actions management establishes through policies and procedures to achieve all objectives/subobjectives and respond to each risk in the internal control system. These can be set at the entity-level or transactions/compliance process level based on the precision needed.

The list below is meant only to illustrate the range and variety of control activities that may use useful to management. The list is not all inclusive and may not include particular control activities your State Agency needs:

- Top-level reviews of actual performance
- Reviews by management at the functional or activity level
- Management of human resources
- Controls over information processing
    - **General Controls** for Information Systems include security management, logical and physical access, configuration management, segregation of duties, and contingency planning
    - **Application Controls** for Information Systems includes controls over input, processing, output, master file, interface, and data management system controls to achieve:
        - **Completeness** – transactions that occur are recorded and not understated
        - **Accuracy** – transactions are recorded at the correct amount in the right account and on a timely basis at each stage of processing
        - **Validity** – recorded transactions represent economic events that occurred and were executed according to prescribed procedures
        - **Confidentiality**
- Physical control over vulnerable assets
- Establishment and review of performance measures and indicators
- Segregation of duties – authority, custody, and accounting to lessen the risk of fraud, waste, or abuse
- Proper execution of transactions and operational/compliance processes
- Accurate and timely recording of transactions and operational/compliance processes
- Access restrictions to and accountability for resources and records
- Appropriate documentation of transactions and internal control

Control Activities can be either **Preventive** or **Detective/Corrective**. The main difference is the timing:

- **Preventive control activity** prevents an entity from failing to achieve an objective or addressing a risk (i.e. review/approval)
- **Detective/Corrective control activity** discovers when an entity is not achieving an objective or addressing a risk before the operation has concluded and corrects the action so the entity achieves the objective or addresses the risk (i.e. reviewing expenditure reports and recording adjusting journal entries if discrepancies are identified).

Also see document posted to DOF Internal Control website "Control Activities and Proper Segregation of Duties" for additional specific examples of both.

Information and Communication:

Oversight bodies and Agency Management uses quality information to support the internal control system. Effective information and communication are vital for an entity to achieve its objectives. Entity Management needs access to relevant and reliable communication related to internal as well as external events.

Information may be obtained from reliable internal and external sources in a timely manner. Sources of data can be operational, financial, or compliance related. This process includes both processing data into information and then evaluating the processed information to ensure it is **quality information** – appropriate, current, complete, accurate, accessible, and provided on a timely basis. Management then uses this quality information to make informed decisions and evaluate the State Agency's performance in achieving key objectives and addressing risks.

Agency management communications quality information up, down and across reporting lines to enable personnel to achieve objectives, address risks, and support the internal control system. In these communications, oversight bodies and agency management assign the internal control responsibilities to personnel in key roles.

Reporting upwards to oversight bodies is necessary for the effective oversight of internal control. Agency Personnel may reach out directly to oversight bodies with known issues or concerns related to fraud, waste, and abuse or other Internal Control Deficiencies within their Agency.

Oversight bodies and Agency Management considers a variety of factors in selecting an appropriate method of communication such as:

- **Audience** – the intended recipients of the communication
- **Nature of Information** – The purpose and type of information being communicated
- **Availability** – information readily available to the audience when needed
- **Cost** – the resource used to communicate information
- **Legal or regulatory requirements** – requirements in laws and regulations

Based on theses factors appropriate methods of communication may be:

- Written document – hard copy or electronic form
- Face-to-face meeting

External parties who State Agency communities with, and obtains quality information from, includes:

- Suppliers
- Contractors
- Service Organizations
- Regulators
- External Auditors
- Government Entities
- General Public

As changes in the entity and its objectives/subobjectives occurs, management changes information requirements as needed to meet these modified objectives and address the modified risks.

Monitoring:

Since internal control is a dynamic process that needs to be adapted continually to the risks and changes an entity faces, monitoring of the internal control system is essential in helping internal control remain aligned with changing objectives, environment, laws, resources, and risks. Internal control monitoring assesses the quality of performance over time and promptly resolved the findings of audits and other reviews. Corrective actions are a necessary complement to control activities to achieve objectives.

Oversight bodies and Agency Management establishes baseline to monitor the internal control system. This baseline is used as criteria in evaluating the internal control system and make changes to reduce the difference between the criteria and current condition. Agency Management performs ongoing monitoring of the design and operating effectiveness of the internal control system as part of the normal course of operations, which includes regular management and supervisory activities, comparisons, reconciliations, and other routine actions.

Self-assessments may be used, or there may be required audits or reviews by internal or external auditors. Evaluations performed by reviewers who do not have responsibility for the activities being evaluated provide greater objectivity.

Agency Management identified changes in the internal control system that either have occurred or are needed because of changes in the entity and its environment. External parties can also help, for example complaints from the general public and regulator comments may indicate areas that need improvement.

Conclusion:

This document establishes basic Statewide Objectives for State Agencies to follow and step-by-step process how to create and maintain their Internal Control System.

This is based on the Green Book, full text can be found at https://www.gao.gov/assets/gao-14-704g.pdf