



*Statewide Internal Control Guidance*

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**Background**

State leadership recognizes the importance of internal controls and as a result SAO will be renewing our focus on this topic. An effective internal control system is maintained by the diligence of every person, has many benefits, and provides reasonable, but not absolute, assurance that an organization's objectives will be achieved. Additionally, an effective internal control system acts as the foundation for managing risks and allows organizations to adapt.

To ensure consistent requirements around internal controls and to increase fiscal accountability within the State, SAO is updating the statewide framework which will be based on SAO's interpretation of the Green Book. This framework contains comprehensive standards, policies, and procedures which organizations will use as guidance for updating and documenting their internal control systems. SAO will also provide general communications, resources, etc. via the SAO website: <http://sao.georgia.gov/internal-controls>. Additionally, SAO will provide ongoing assistance, guidance, and monitoring as necessary. This framework will apply to all organizations of state government meaning, without limitation, any agency, organization, authority, department, institution, board, bureau, commission, committee, office, or instrumentality of the State of Georgia.

**Green Book Structure - Components, Principles, and Attributes**

Internal control is a process that provides reasonable assurance that the objectives of the organization will be achieved. Also, internal control is not one event, but a series of actions that occur throughout an organization's operations. Therefore, internal control is an integral part of the operational processes and not a separate system.

The Green Book presents internal control concepts through a hierarchical structure of components, principles and attributes, which are all relevant to establish an effective internal control system.

## The Five Components and 17 Principles of Internal Control

### Control Environment

1. The oversight body and management should demonstrate a commitment to integrity and ethical values.
2. The oversight body should oversee the entity's internal control system.
3. Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.
4. Management should demonstrate a commitment to recruit, develop, and retain competent individuals.
5. Management should evaluate performance and hold individuals accountable for their internal control responsibilities.

### Risk Assessment

6. Management should define objectives clearly to enable the identification of risks and define risk tolerances.
7. Management should identify, analyze, and respond to risks related to achieving the defined objectives.
8. Management should consider the potential for fraud when identifying, analyzing, and responding to risks.
9. Management should identify, analyze, and respond to significant changes that could impact the internal control system.

Source: GAO. | GAO-14-704G

### Control Activities

10. Management should design control activities to achieve objectives and respond to risks.
11. Management should design the entity's information system and related control activities to achieve objectives and respond to risks.
12. Management should implement control activities through policies.

### Information and Communication

13. Management should use quality information to achieve the entity's objectives.
14. Management should internally communicate the necessary quality information to achieve the entity's objectives.
15. Management should externally communicate the necessary quality information to achieve the entity's objectives.

### Monitoring

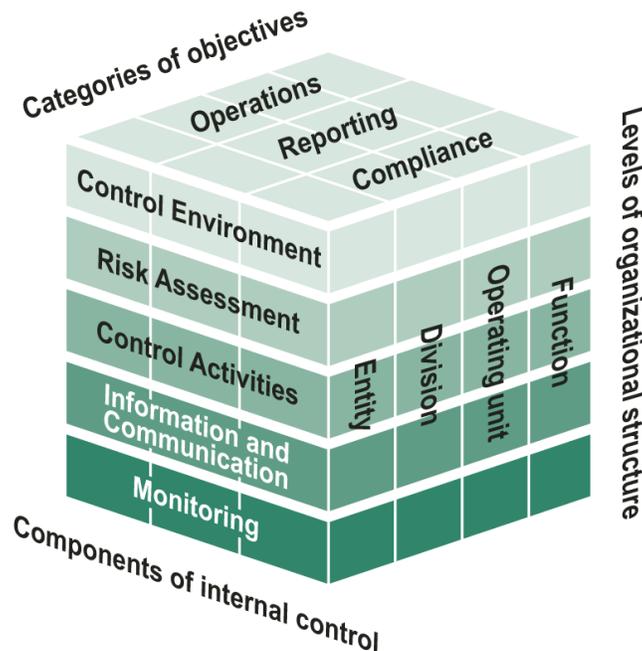
16. Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.
17. Management should remediate identified internal control deficiencies on a timely basis.

The five components must be properly designed, implemented, and then operate together, for an internal control system to be effective. The 17 principles support the associated components and represent additional requirements for an effective internal controls system. The various attributes provide further explanation and documentation requirements, or include examples of procedures that may be appropriate for an organization.

A direct relationship exists between the objectives of the organization, the five components of internal control, and the organizational structure<sup>1</sup>. For example, objectives are what an organization wants to achieve, and the five components detail what is required to achieve those objectives. This relationship is depicted in the form of a cube developed by COSO. The three categories into which an organization's objectives can be classified are represented by columns labeled at the top of the cube. The five components are represented by the rows, and each component applies to all three categories of objectives and the organizational structure. The organizational structure is represented by the third dimension of the cube.

<sup>1</sup> Organizational structure encompasses the operating units, operational processes, and other structures management uses to achieve their objectives.

**The Components, Objectives, and Organizational Structure of Internal Control**



Sources: COSO and GAO. | GAO-14-704G

**Objectives of an Organization**

Management, with oversight by an oversight body, sets objectives to be accomplished in order to meet the organization’s mission and to be in compliance with applicable laws and regulations. These objectives may be set as part of the strategic planning process, but must be set before designing the organization’s internal control system. After the overall objectives are set, management can set related subobjectives for divisions/program within their organizational structure.

Objectives are generally grouped into these categories:

- Reporting – reliability of internal and external reports. This would include any type of financial report such as the Budgetary Compliance Report (BCR), and year-end forms which are used to create the Comprehensive Annual Financial Report (CAFR).
- Operational – effectiveness and efficiency of operations. This would include making sure the organizational mission is accomplished at the least cost possible and also includes the safeguarding of assets.
- Compliance – compliance with applicable laws and regulations.

These are distinct but overlapping categories. For example, a particular objective can fall under more than one category, can address different needs, and may be the direct responsibility of different staff.

**Roles in an Internal Control System**

Everyone in the organization has a responsibility for internal controls. In general, roles in an organization’s internal control system can be categorized as follows:

- Management – management is directly responsible for all activities of an organization, including the design, implementation, and operating effectiveness of an organization’s internal control system. Furthermore, management sets the tone at the top which reflects the integrity, ethics, and other factors of a control environment.

- **Personnel** – state personnel help management design, implement, and operate an internal control system and are responsible for reporting issues. Specifically, personnel at any level should notify someone with authority about noncompliance with the code of conduct, other policy violations or illegal acts.
- **Oversight Body** – the oversight body is responsible for overseeing the strategic plan and the accountability of the organization. This includes overseeing management’s design, implementation, and operation of the internal control system, and their oversight is implicit in SAO’s framework. For some organizations, an oversight body may be a board (elected or appointed members who oversee the organization) or a few members of senior management.
- **Internal Auditors** – internal auditors play an important role in evaluating the effectiveness of the internal control system and provide ongoing monitoring. If there are not internal auditors in the organization, then management needs to ensure someone else is performing this role.

External auditors, including the Georgia Department of Audits and Accounts, are not considered part of an organization’s internal control system. While management may incorporate recommendations by these auditors, responsibility for an organization’s internal control system resides with management.

### **Overall Design and Implementation of an Internal Control System**

Management should use a risk-based approach to identify the key risks, including fraud risks<sup>2</sup> that would prevent an organization from achieving their defined objectives. This approach recognizes that not all risks are equal, considers cost factors in relation to expected benefits, and drives allocation of more resources to the areas of highest risk. Management may decide how an organization evaluates the costs vs. benefits, however, cost alone is not an acceptable reason to avoid implementing necessary controls. In the end, management needs to implement and design an internal control system that effectively and efficiently addresses the identified risks, and allows the organization to achieve their objectives. However, SAO’s framework does not prescribe specifically how management should design, implement, and operate their internal control system. Therefore, no two organizations will have an identical internal control system because of differences in factors such as mission, regulatory environment, size, and management’s judgment.

### **Evaluation of the Internal Control System**

Once the internal control system has been properly designed, management then determines if the organization has placed the system into operation as designed. Management determines if the controls were applied at relevant times, in a consistent manner, and by whom they were applied. A deficiency exists when a control does not operate as designed, or when the person performing the control does not possess the appropriate authority or competence.

Management then evaluates the significance of identified deficiencies, by assessing its impact on achieving the defined objectives, likelihood of occurrence, and nature of the deficiency. The evaluation of deficiencies will vary by organization because of differences in the organization’s objectives and other factors. Management needs to correct the deficiency, if it is deemed to be significant, to ensure the internal control system is operating as designed. The oversight body oversees management’s evaluation of the significance of deficiencies to ensure they have been properly considered and corrected.

### **Service Organizations (External Third Parties)**

Management may engage external third parties to perform certain operational processes for the organization, such as accounting and payroll processing. For the purpose of this framework, these external

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<sup>2</sup> Fraud includes the intentional material misstatement in the financial statements or intentional loss or misuse of assets.

third parties are referred to as service organizations. However, management retains responsibility for the processes assigned to these service organizations. Therefore, management needs to understand the controls at each service organization and how the service organization's internal control system impacts their own internal control system.

### **Documentation Requirements**

Documentation is a necessary part of an effective internal control system. The level and nature of documentation will vary based on the size of the organization and the complexity of the internal control system. Therefore, management uses judgment in determining the extent of documentation that is needed, however the Green Book has outlined some minimum documentation requirements.

### **Other Resources**

More information on the Green Book, internal controls, and related topics, can be found at:

- U.S Government Accountability Office (GAO) <http://www.gao.gov/greenbook/overview>
- Committee of Sponsoring Organizations of the Treadway Commission (COSO) <http://www.coso.org/>
- American Institute of CPAs (AICPA) <http://www.aicpa.org/Pages/default.aspx>
- Government Accounting Standards Board (GASB) <http://www.gasb.org/>
- Government Finance Officers Association (GFOA) <http://www.gfoa.org/>
- The Institute of Internal Auditors (IIA) <https://na.theiia.org/Pages/IIAHome.aspx>

### **Conclusion**

The following chapters of the manual are designed to assist management's understanding of internal control concepts so they can update the design of, implement and evaluate an effective internal control system. This manual is based on SAO's interpretation of Green Book and is intended to be a flexible set of principles, guidelines, and tools.

For further information on SAO's framework or for further internal control assistance, organizations should visit SAO's website:

<http://sao.georgia.gov/internal-controls>