

Section II - Statewide Internal Control Framework

STATEWIDE INTERNAL CONTROL FRAMEWORK

Introduction

The Hawaii State Government is a very complex organization, consisting of 17 separate Executive Branch departments and employing approximately 53,000 personnel. These departments have their own fiscal staff, and because of the limitations of the State's financial accounting and management information system, some of the departments have set up their own accounting systems. Every citizen of Hawaii is touched by state government, with thousands of individuals and families using State services daily. In order to successfully govern the State in such complex environments, operations must be effectively managed. Internal control enables management to effectively deliver services to Hawaii's citizens, and to help ensure the reliability of financial statements and compliance with laws and regulations.

Because of the essential importance of internal controls and the complexity of state government, the State Comptroller has created this internal control framework to establish a single definition of internal control applicable statewide and also to detail the elements which a sound system of internal control should possess.

Internal Control – Definition

Internal Control means different things to different people. Common understanding of internal control have centered on the routine actions surrounding certain transactions meant to ensure correctness and reduce risk of loss. While these are examples of specific internal controls, a more comprehensive definition is required. The following is the State's definition of internal control:

Internal Control is a process based on the State's organizational structure, work and authority flows, employees and management information systems, designed to help management accomplish its specific goals or objectives. It is a course by which the State's resources are directed, monitored, and measured. It plays an important role in preventing and detecting fraud and protecting the State's resources, both physical and intangible.

At the State and department level, internal control objectives relate to the reliability of financial reporting, effectiveness and efficiency of operations, timely feedback on the success of operational or strategic goals, and compliance with laws and regulations. At the specific transaction level, internal control refers to the actions taken to achieve a specific objective. Internal control procedures reduce process variations, leading to more predictable outcomes.

Elements of Internal Control

Internal Control consists of the following five interrelated elements.

- Control Environment
- Risk Assessment

- Control Activities
- Information and Communication
- Monitoring

These elements interact with all the State's operational processes and must be in place and properly functioning for an effective system of internal control to succeed. The following paragraphs describe how these elements function within a system of internal control.

Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other elements of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people and the attention and direction provided by a governing body. As the foundation, if the control environment of an organization is compromised, all internal control elements will face severe problems.

Risk Assessment

Every entity faces a variety of risks from external and internal sources that must be assessed. For risk assessment to function properly, objectives must be set and risk tolerance known. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be mitigated. Because conditions change, risk assessment must be a perpetual activity.

Control Activities

Control activities are those specific policies, procedures and tasks that help provide reasonable assurance that objectives will be met. They help ensure that necessary actions are taken to mitigate risks. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operations, security of assets and segregation of duties.

Information and Communication

Information pertinent to the operation of an organization must be identified, captured and communicated in an effective form. Effective communication must occur in a broader sense as well, flowing down, across and up the organization. Employees must have a clear understanding of management expectations and management must hear and understand employees' concerns. The State's citizens must have access to necessary information. With modern communication means available, a state government entity has little reason not to communicate information properly.

Monitoring

Monitoring is a process that assesses and seeks to mitigate the risk that internal controls within the State will not provide reasonable assurance that operational, reporting and legal/regulatory objectives are met. Although external audits conducted by the Office of the Auditor do provide a monitoring function related to controls, primary monitoring must be a function internal to state government. Such internal monitoring can occur within the following formal activities:

- Internal Audit Activities
- Self-Assessment of Internal Control Questionnaires

Also important to the monitoring element are the procedures that are performed by a State entity that allow its management to attest to the accuracy of financial reporting information regularly submitted to DAGS. Monitoring must also occur on a less formal basis as a part of management's operation of government.

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These components should be considered inextricably linked both with one another and with the definition of internal control. The objectives of a system of internal control cannot be achieved without the working of each element within the system. State government strives to achieve the internal control objectives of efficient and effective operations, sound financial reporting and compliance with laws and regulations. These five elements are the means of achieving reasonable assurance that those objectives will be met.

Reasonable Assurance

Internal control aims for reasonable assurance. Even a highly effective system of internal controls cannot guarantee that an organization will meet all objectives. Any system designed to strive for such a goal would consume many resources and inhibit delivery of government services. A sound system of internal control finds the balance between assurance and operations and offers a reasonable assurance that objectives will be met.

Responsibilities

Everyone in an organization has responsibility for internal control. Management must implement the system and set the "tone at the top" but all levels within an organization must take ownership of internal control. Responsibilities must be effectively communicated to all levels and support of the system of internal control must be considered a part of proper workplace performance. When necessary, understanding must be communicated through formal training methods.

Note: This Framework contains information adapted from the Committee of Sponsoring Organizations of the Treadway Commission's Internal Control – Integrated Framework, published in 1992.