
TITLE 1

OVERVIEW OF INTERNAL CONTROL

INTRODUCTION

INTEGRATED FRAMEWORK

Overview

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission published *Internal Control—Integrated Framework* (the COSO Report) in 1992. COSO has established a common definition of internal controls, standards, and criteria against which companies and organizations can assess their control systems. Because this framework is widely accepted, it will be used as the basis for all internal control matters related to utility districts.

Definition of Internal Control

Internal control is a process that is developed by the utility district to provide reasonable assurance that the following categories of objectives will be achieved:

- the utility district’s financial reporting will be reliable;
- the utility district will be operated effectively and efficiently; and
- the utility district will comply with applicable laws, regulations, contracts and grant agreements.

The above definition “reflects certain fundamental concepts”. Those concepts are:

- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is affected by people. It is not merely policy manuals and forms, but it involves people at every level of an organization.
- Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity’s management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

Internal controls are most effective when they are built into the entity’s infrastructure and are part of the essence of the enterprise. They should be built in rather than built on. (*Internal Control – Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission, 1994 Edition).

When management sets objectives, they can be broadly categorized into:

- Entity-wide objectives
- Activity-level objectives

Entity-wide objectives are broad statements and guidance on what the utility district wants to achieve. These objectives, as identified in this manual, are very general in order to

encompass many of the basic responsibilities of utility districts in Tennessee. These general entity-wide objectives should be tailored to meet the unique requirements of each utility district without abandoning the risks and related control procedures that are considered essential to all utility districts in Tennessee.

Activity-level objectives are developed out of the broad entity-wide objectives. These objectives are often stated as goals and should address all significant operating activities of the utility district. As with the entity-wide objectives, for purposes of this manual we have identified activity-level objectives which are relevant to all Tennessee utility districts. While each utility district may identify their activities in different ways, the relevant risks and related control procedures that are included in this manual, or adequate alternative control procedures, should be incorporated into the utility district's activity-level objectives.

Components of Internal Control

The COSO Report identifies five (5) main components of internal control:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

The control environment is the foundation for all the other components. It “sets the tone at the top”. That is, if management (the board.) views internal control as important, the rest of the organization will likely follow that same path. Control environment factors include integrity, ethical values, management's philosophy and operating style, organizational structure, assignment of authority and responsibility, and human resource policies and practices.

A precondition to risk assessment is the establishment of objectives. Once objectives have been established, risks that could impair the utility district's ability to achieve those objectives should be identified. That is, board members should identify the factors or conditions that could occur that would cause a utility district to be partially or totally unable to achieve the objectives. Assessing the risks related to achieving those objectives is an ongoing process and is a critical component of an effective internal control system.

Control activities are management's specific policies and procedures that help ensure that the risks related to achieving management's objectives are addressed.

Information and communication systems should provide reliable reports for both internal and external purposes. The means of communicating information in the organization will significantly impact whether objectives are achieved.

Monitoring the internal control system provides assurance to management that: policies and procedures are being followed; information is being communicated accurately and timely; and, risks are being identified and appropriately addressed. In addition, it ensures that internal control continues to operate effectively, since processes, goals, and

circumstances are not static and changes in those areas will necessitate changes in internal control.

Summary

A good internal control structure is essential to providing reasonable assurance that utility districts are achieving their objectives. Such objectives include, but are not limited to, utilizing resources in compliance with laws and regulations and providing reliable, cost efficient services. An adequate control structure will provide information that helps detect errors and fraud, and provides reasonable assurance that financial reports are accurate. It will limit the opportunity for theft or unauthorized use of assets, including cash, inventory and capital assets.

The remainder of this manual is not designed to be an exhaustive analysis of the different components of internal control or a comprehensive listing of compliance requirements. Rather this manual establishes the minimum requirements of the Comptroller's office related to internal control and compliance. In developing these minimum requirements, certain objectives and risks which apply to many, if not all, utility districts have been identified. Developing an adequate internal control system requires continual analysis and modification to address changing circumstances. The board should identify and address additional objectives that are relevant to the district's operations.