STATE OF TENNESSEE

INTERNAL CONTROL AND COMPLIANCE MANUAL

FOR GOVERNMENTAL ENTITIES

AND

OTHER AUDITED ENTITIES

IN TENNESSEE

Internal Control Framework

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PREFACE

Local governments and other entities detailed below must establish and maintain an adequate internal control system for purposes of financial reporting, managing operations, and legal compliance.

Various state statutes require the Department of Audit, Comptroller of the Treasury, to prescribe a uniform accounting system for entities that handle public funds. Those statutes require officials to adopt and use the system and the character of books, reports, and records designated by the Comptroller of the Treasury. An accounting system is defined as the methods and records established to identify, assemble, analyze, classify, record and report a government's transactions and to maintain accountability for the related assets and liabilities. Those methods would necessarily include establishing, documenting, and implementing adequate internal controls. Some of those requirements are listed below:

- State, county, municipal, and utility district offices – Section 9-2-102, *Tennessee Code Annotated (TCA)*
- Emergency communication districts – Section 7-86-304, *TCA*
- Development district offices – Section 13-14-108, *TCA*
- Human resource agencies – Section 13-26-109, *TCA*
- Public charter schools – Section 49-13-111(m), *TCA*
- Regional development authorities – Section 64-7-105, *TCA*

In addition, Section 9-18-102(a), *TCA,* was amended to expressly require each county, municipal, and metropolitan government to establish and maintain internal controls.

The U.S. Office of Management and Budget (OMB) has established internal control guidance for all entities that receive federal awards at Code of Federal Regulations (CFR) 200.303. This guidance requires all entities to establish and maintain an effective system of internal control over federal awards. The OMB guidance further recommends implementing a system of internal control in accordance with internal control standards published in September 2014 by the U.S. Government Accountability Office (GAO) in *Standards for Internal Control in the Federal Government* (Green Book), as one method of complying with CFR 200.303.

The *Internal Control Manual for Local Governmental Entities and Other Audited Entities in Tennessee* (the "Internal Control Manual") should be used by all local governments listed above (including entities created by interlocal agreements between those entities) as well as any other entity that has a similar statutory requirement. Other entities, including those participating in contracts with the State of Tennessee that include contractual provisions requiring the establishment of internal controls, should consider the provisions of this manual when establishing internal controls.

PREFACE

This manual summarizes and gives examples of internal controls based on standards for establishing internal controls published in the September 2014 version of GAO's Green Book. Accordingly, this manual refers to different levels of oversight responsibility as follows:

- Governing body refers to the county commission, city council, board of directors, or similar authorities.
- Oversight body refers to an appointed body designated to perform oversight at the direction of the governing body.
- Management refers to elected officials or employees who have direct responsibility for the day-to-day operations of the entity including the implementation of internal controls.

Summary:
This internal control manual is designed by the Division of Local Government Audit for the use of governing and oversight bodies and the management of entities in Tennessee. Management is responsible for designing and implementing a system of internal control. Auditing standards do not allow auditors to design or implement your system of internal control and auditors cannot be a substitute for a system of internal control.

This manual is based on principles, as opposed to providing a detailed method of implementing internal controls. This is because the manual is based on the GAO Green Book, which is principles based as well. In addition, it would be physically impossible to develop a detailed internal control implementation plan because of the variety of entities that operate in Tennessee.

While the 17 Principles presented in this manual are recommended, use of these exact principles are not required. **Establishing and maintaining a system of internal controls is required by state and federal law. Implementing the five (5) components of internal control should be considered mandatory.**

This manual is effective upon release, unless otherwise noted.

INTRODUCTION

OVERVIEW OF INTERNAL CONTROL

The U.S. Government Accountability Office (GAO) has established a common definition of internal controls, standards, internal control components, principles and attributes. The document that contains this information is often referred to as the Green Book. Because this GAO Green Book framework is widely accepted, it will be used as the basis for all internal control matters related to entities covered by this internal control manual as outlined in the preface.

Definition of Internal Control

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

- **Reporting** – financial reporting will be reliable;
- **Operations** – effectiveness and efficiency of operations; and
- **Compliance** – compliance with applicable laws, regulations, contracts and grant agreements.

The above definition "reflects certain fundamental concepts." Those concepts are:

- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.
- Internal control comprises the plans, methods, policies, and procedures used to fulfill the mission, strategic plan, goals, and objectives of the entity.
- Internal control is an integral part of the organization not a separate system within the organization.
- 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 people at every level of an organization.
- Internal control increases the likelihood that an entity will achieve its objectives. However, it can only be expected to provide reasonable assurance, not absolute assurance, that all of the organization's objectives will be met.

While each organization may identify its mission, strategic plan, objectives, and plans for achieving its objectives in different ways, the Green Book approaches internal control through a hierarchical structure of five (5) components and seventeen (17) principles. The Green Book also contains additional information in the form of attributes. Attributes are presented under the heading title: "This Involves." These attributes provide further explanation of the principles and documentation requirements.

Components of Internal Control

The five (5) main components of internal control are:

1. **Control environment** – the foundation for an internal control system
2. **Risk assessment** – assesses the risks facing the organization as it seeks to achieve its objectives
3. **Control activities** – the actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system
4. **Information and communication** – the quality information management and personnel communicate and use to support the internal control system
5. **Monitoring** – activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews

There is a direct relationship between the organization's objectives, the five components of internal control and the organizational structure of the organization. The five components apply to all three categories of objectives and all levels of the organizational structure. The seventeen (17) principles support the components of internal control.

Summary

A good internal control framework is essential to providing reasonable assurance that organizations are achieving their objectives. Such objectives include, but are not limited to, utilizing public resources in compliance with laws, regulations and budgetary limitations. An adequate control framework 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 designed to give an overview of the seventeen (17) principles related to the five (5) components of internal control listed above as they relate to the objectives and organizational structure of an organization. It is not intended to be an exhaustive analysis of internal control. Rather this manual provides examples regarding the development of an internal control system within the framework addressed in the Green Book. The examples are not intended to be mandatory implementation guidance. They are merely examples for your consideration. Developing an adequate internal control system requires written documentation as well as continual analysis and modification to address changing circumstances. Officials should identify and address their specific objectives within the framework set out in the Green Book or use a similar comprehensive framework that includes each of the five components of internal control.

COMPONENT 1

CONTROL ENVIRONMENT

GAO Green Book Principles 1 through 5

The control environment is the foundation for any internal control system. There are five (5) principles related to the control environment

1. ***The oversight body and management should demonstrate a commitment to integrity and ethical values.***

This involves:
Setting the foundational tone at the top
Establishing standards of conduct
Enforcing adherence to standards of conduct

Application:
The governing body or other oversight body and management's directives, attitudes, and behaviors should reflect the integrity and ethical values expected throughout the entity.

Develop, regularly review, and update a manual that addresses:

- Expectations regarding business practices and ethical behavior (includes theft, computer use, sexual harassment, pay scales, promotions, dress code, probationary period, evaluations, conflict of interest issues, etc.)
- Disciplinary policies and procedures
- Methods of reporting fraud, other misconduct, sexual harassment, etc.

Examples:

- Require employees to complete an annual form identifying any conflict of interest that exists or assert that he/she does not have any conflict of interest with any vendor, provider, supplier or other individual within the organization or external to the organization. Require employees to report, within five (5) days any conflict of interest that the employee becomes aware of that has not been previously reported.
- The governing body and management develop a code of professional conduct that is presented to employees at their hiring and is reviewed annually with all employees.
- Management stresses ethics, compliance with laws and regulations, and following internal controls at all employee meetings.

2. ***The oversight body should oversee the entity's internal control system.***

<u>This involves:</u>
Establishing an oversight structure
Determining who will be responsible for oversight of the internal control system
Establishing a method for remediation of deficiencies

<u>Application:</u>
The governing body should oversee the design, implementation, and operation of the organization's internal control system as well as take appropriate action to resolve deficiencies. The governing body may appoint a separate oversight body (such as an audit committee) that has the independence and qualifications needed to impartially evaluate, scrutinize, question activities, and oversee the design, implementation, and operation of the organization's internal control system as well as take appropriate action to resolve deficiencies. The oversight body should report regularly to the governing body. Management should be directly involved in developing the internal control system and is responsible for implementing and monitoring the system for compliance.

<u>Examples:</u>
- The conflict of interest form, code of professional conduct, and internal control manual are presented and explained to the governing body. The governing body approves each document.
- The governing body appoints an oversight body composed of at least five (3) individuals. The collective knowledge of those individuals should include: legal representation, accounting, investing and cash management, building codes, internal control, computer operations and security, grants management, debt marketing and financing. The oversight body should ensure that it has access to competent outside experts when it does not have requisite knowledge in these or other areas of expertise.
- The governing body or appointed oversight body reviews the annual audit report for internal control issues, meets with management officials, and ensures appropriate action is taken to correct deficiencies.

3. ***Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.***

<u>This involves:</u>
Establishing an organizational structure
Assigning responsibility and delegating authority within the organizational structure
Documentation of the internal control system

Application:

- Establish, document and regularly review and update a simple and flexible organizational plan that clearly addresses the assignment of authority and responsibility
- Develop a manual that provides sufficient documentation of internal control to communicate to personnel their responsibilities as well as to monitor and evaluate the controls

Examples:

- Create an organizational chart as an overview of the lines of authority and responsibility.
- Develop a formal, written internal control document that focuses on individual responsibilities within each area of functional responsibility (e.g. accounts payable/purchasing).

4. ***Management should demonstrate a commitment to recruit, develop, and retain competent individuals.***

This involves:

Developing expectations of competence
Recruitment, development, and retention of individuals
Succession and contingency plans and preparation

Application:

Develop and regularly review and update a manual that addresses:

- Job skills requirements (job descriptions, certifications, continuing professional education, education in new accounting standards, education in new laws, education in federal grant requirements, computer software education, and other general education and training requirements, etc.)
- Employee benefits (leave, flex plans, health insurance, 401k, pension, other postemployment benefits, etc.)
- The business continuity plan for succession and emergencies

Examples:

- Management develops a job description for the chief accountant, requiring (1) at least five (5) years of experience at a comparable organization; (2) at least three (3) years of supervisory experience; (3) computer skills that include a good working knowledge of word processing, spreadsheets and accounting software; (4) knowledge of generally accepted governmental accounting principles; and (5) proficiency in written and oral communication.

- Annual training will be provided to ensure that the chief accountant stays well informed about changes in accounting and reporting, changes in laws that affect payroll and payroll related activities, changes in laws that affect purchasing, grants administration and emergency management training. As software is updated, adequate training will be provided to ensure continued proficiency in computer skills. The chief accountant will communicate significant matters to staff through annual or semi-annual training events.
- Employees are encouraged to obtain certifications such as CPA and CMFO and the entity agrees to pay for continuing professional education requirements.
- Background checks are performed for all employees involved in financial transactions such as collecting and disbursing funds.

5. ***Management should evaluate performance and hold individuals accountable for the internal control responsibilities.***

This involves:
Enforcing accountability
Consideration of excessive pressures

Application:
Develop and regularly review and update a manual that addresses:
- Periodic job evaluations and corrective action(s) to be taken when there are deficiencies
- Periodic evaluation of employee workload pressure and methods for communicating and implementing required changes to alleviate excessive workload pressures (whether created by management goals, time constraints, budgetary factors, cyclical demands, or increased workload buildup over time)

Examples:
- Management develops a policy requiring a job evaluation for each new employee at 30 days, 90 days, 6 months, and 1 year. After the first year, job evaluations will be conducted annually. New employees have a 6-month probationary period. During that time, a corrective action plan will be developed for any deficiency noted as a result of an evaluation. If the same deficiency is noted in a subsequent evaluation, a recommendation for terminating employment or extending the probationary period will be considered. Significant improvement is expected prior to the 6-month evaluation, when a recommendation will be made to extend the probationary period, terminate employment or retain the individual as a non-probationary employee.

- Management requires service organizations such as outside billing and collection companies to provide a Service Organization Control (SOC) report. This report is a method of holding service organizations accountable for their internal control systems.
- Segregation of duties and rotating job responsibilities are methods of implementing internal controls. These methods also help to identify and allow for the alleviation of excessive workload pressures on individual employees.
- Employees who work excessive overtime should be evaluated for workload pressure. Employees who work overtime but are not paid for their time may leave the employer open for legal action by the U.S. Department of Labor.

COMPONENT 2

RISK ASSESSMENT

GAO Green Book Principles 6 through 9

Having established an effective control environment, management assesses the risks facing the entity as it seeks to achieve its objectives. Generally speaking, risk assessment means asking questions about what could go wrong. There are four (4) principles related to risk assessment.

1. ***Management should define objectives clearly to enable the identification of risks and define risk tolerances.***

   This involves:
   Defining the entity's objectives
   Defining the entity's tolerance or threshold for risk

   Application:
   Develop and regularly review and update a document that addresses:
   - The organization's mission
   - The organization's goals and objectives in sufficient detail to allow for performance risk assessments in a reasonably consistent manner
   - The organization's risk tolerances or risk threshold for each objective in sufficient detail to allow for the appropriate design of an internal control system. Risk tolerances or thresholds should be assessed considering laws, regulations, generally accepted accounting principles, other standards, grant management, internal standards of conduct, oversight structure, organizational structure, and expectations of competence, etc.
   - The organization's judgments about materiality, both qualitatively and quantitatively (i.e. risk threshold)

   Examples:
   - Surety bonds and/or employee dishonesty insurance should be purchased to mitigate the risk of loss of funds due to errors, irregularities, or fraud.
   - Implement sufficient internal controls to reasonably ensure that the organization does not experience a loss greater than $15,000 (i.e. a risk threshold) within any fiscal year.

- Surety bonds and/or employee dishonesty insurance will be obtained for any individual who handles more than $15,000 annually or as required by law. Reevaluations of surety bond coverage needs should be made when any change in personnel occurs, either through reassignment, new hire, etc. If total revenue increases by more than ten (10) percent of budgeted revenue (i.e. a risk threshold), a reassessment of surety bond coverage and internal control will be conducted.

2. ***Management should identify, analyze, and respond to risks related to achieving the defined objectives.***

<u>This involves:</u>
Identification of risks
Analysis of risks
Response to risks

<u>Application:</u>
Develop and regularly review and update a document that addresses:
- The risks associated with the organization's objectives
- The methodology for determining if the risk identified is material to the organization
- The action(s) to be taken to mitigate the risk

<u>Examples:</u>
Operations, Reporting, and Compliance Risk:

Objectives – revenue will be properly recorded in compliance with generally accepted accounting principles, receipted, and deposited in accordance with laws, regulations, and contractual requirements

Risk (What could go wrong?) – revenue may not be recorded in compliance with generally accepted accounting principles, may not be receipted or deposited, and, as a result, reporting, contractual, and legal requirements will be violated

Response to risk – the receipting, depositing and accounting functions will be handled by different individuals; separate cash drawers will be used by each individual receiving funds and will be reconciled at the end of the day to the daily cash report; prenumbered receipts will be issued; daily cash reports will be prepared and reviewed by a manager; training will be structured to ensure that all individuals understand the relevant laws, reporting requirements, contractual requirements, program requirements, and any changes in same; monthly reports will be prepared and reviewed to determine reasonableness and accuracy and report variances will be investigated; and budgetary comparisons will be performed to determine reasonableness and accuracy and variances will be investigated

The following list presents examples of other types of entity-wide objectives that might be considered. Each objective involves certain risks that must be addressed and each risk will require the implementation of internal controls.

Entity-wide objectives:

Operations Objectives –
- Ensure that the entity's resources are adequately safeguarded
- Provide taxpayer services efficiently and effectively
- Limit the need for tax increases
- Provide for the long-term stability of the municipality
- Provide a stable and rewarding work environment for employees

Reporting Objectives –
- Provide timely interim financial reports and schedules for evaluating the results of operations
- Issue timely financial reports that comply with generally accepted accounting principles, the additional requirements of the Tennessee Comptroller of the Treasury, and federal grant requirements

Compliance Objectives –
- Comply with all relevant laws, regulations, contracts, and grant agreements

3. ***Management should consider the potential for fraud when identifying, analyzing, and responding to risks.***

This involves:
Considering what types of fraud could occur
Examining the fraud risk factors
Responding to any identified fraud risks

Application:
Review and attend training to identify types of fraud that can occur. Fraud types include fraudulent financial reporting, theft of assets, and corruption (i.e. bribery and other illegal acts). Fraud risk factors include incentive or pressure, opportunity, and attitude or rationalization. Internal controls specifically relate to opportunity. Review organization operations to determine if and how a fraud could occur. Consider the loss potential and determine the acceptable level of risk that the organization is willing to accept. Develop controls to limit the risk of fraud.

Example:
Operations and Compliance Fraud Risk:

Objectives – revenue will be properly recorded, in compliance with generally accepted accounting principles, receipted, deposited, and expended in accordance with laws, regulations, and contractual requirements.

Fraud Risk (What can go wrong?) – cash can be stolen and the individual taking the cash cannot be identified; grant funds can be expended for personal purchases or other nonallowable purchases.

Response to risk – the receipting, depositing and accounting functions will be handled by different individuals; separate cash drawers will be used by each individual receiving funds and will be reconciled at the end of the day to the daily cash report; prenumbered receipts will be issued; daily cash reports will be prepared and reviewed by a manager and variances will be investigated; grant expenditures will be reviewed by a manager and expenditures exceeding $5,000 (i.e. a risk threshold) will require two levels of approval.

4. ***Management should identify, analyze, and respond to significant changes that could impact the internal control system.***

This involves:
Identification of changes in accounting principles, accounting systems, personnel, laws, the business environment, etc.
Analysis of and response to these changes

Application:
New Grant - Identify risks during the planning process for all new grant programs, projects, and activities. Review controls to determine what changes need to be made to ensure that grant objectives are met.

Example:
Management will review all new grant applications and grant agreements and attend training to identify potential risks due to changing grant requirements or other circumstances. Management will, at least annually, consider technological developments, employee turnover, new programs, new accounting standards, new laws and regulations, and economic growth or decline to determine whether or not changes in internal controls need to be implemented. Recommendations for changes will be reviewed and implemented as necessary. The implementation will include training for all personnel involved in the processes that require change.

COMPONENT 3

CONTROL ACTIVITIES

GAO Green Book Principles 10 through 12

Control Activities are the actions management establishes through internal control policies and procedures to achieve objectives and manage risks. Fundamental examples of control activities include issuing receipts and purchase orders, reconciling the bank statement, and division (i.e. segregation) of duties. **The Division of Local Government Audit has developed illustrative Internal Control - Segregation of Duties Checklists that are available for several county offices. These can be found at our website http://comptroller.tn.gov/la/InternalControl.asp . The checklists are mainly designed for smaller offices, which sometimes have difficulty adequately segregating duties. The concepts demonstrated in the Internal Control Checklists can be used to implement segregation of duty controls in other offices.** There are three (3) principles related to control activities.

1. ***Management should design control activities to achieve objectives and respond to risks.***

   <u>This involves:</u>
   Responding to identified objectives and risks
   Designing appropriate types of control activities
   Designing control activities at various functional and structural levels
   Adequately dividing (i.e. segregating) duties among employees

   <u>Application:</u>
   Develop and periodically review and update a procedures manual that documents:
   - The specific actions designed to address entity objectives and risks. These have been identified during the process of defining responsibilities, delegating authority, assessing risks related to the entity at Components 1 and 2
   - The specific actions designed to address entity objectives and risk at various levels in the organization
   - The division (i.e. segregation) of duties and/or implementing compensating controls designed to mitigate risks related to assigning duties and responsibilities among employees

Example 1 – Cash Receipts:

Management has determined that one of its objectives is to provide cost effective reliable services to the residents of the local entity. Several of the services involve collection of cash from sources such as property taxes, law enforcement, courts, solid waste management, and other utilities. Management has identified the different types of risks associated with each of these activities. This example addresses the types of control activities that should be considered to address risks related to cash collections and to address operational, reporting, and compliance objectives. This is only an example. It is not designed to be all inclusive nor is the example relevant to all entities or all cash collection locations. The example does serve to illustrate that even simple transactions like accepting cash have many risk variables.

Responsibility for each step of cash handling and recording should be clearly established. If possible, the employees who receive cash collections (cashiers) should not be the same employees who maintain the books and records (bookkeepers). Entities are encouraged to **not** accept cash when possible (accepting checks, money orders, and credit cards is generally less susceptible to employee fraud.)

Consider the following issues related to controls over cash receipting.

- Who receives and opens mail-in collections
- Who issues receipts for mail-in collections
- Determining all mail-in receipts are recorded
- Establishing separate cash drawers for cashiers
- Establishing separate passwords for each computerized receipting station
- Issuing prenumbered receipts
- Ensuring customers receive a copy of receipts
- Conspicuously posting a sign that reads "You must receive an official receipt or your transaction is not complete."
- Stamping checks "For Deposit Only" including a bank account number
- Accepting credit card payments including credit card transaction fees
- Avoid using a manual receipt book. If a manual receipt book is utilized, it must be an official receipt book.
- Receipt format. Each receipt should include a place to indicate the purpose, type of payment (i.e. cash, check, money order, credit card, etc.), and include a place for an employee's initials.
- Posting or updating accounting records for daily receipts and deposits
- Standardizing daily check-out procedures - each employee should checkout to a certain amount of cash each day.
- Depositing the daily collections. Deposit slips should be itemized between cash, checks, money orders, credit card receipts, etc.
- Depositing cash collections intact. Each deposit should equal all receipts for a given day.
- Taking the deposit to the bank and obtaining a bank deposit receipt.
- Overnight storage of cash for safekeeping.

- Verifying the amount on the bank deposit slip with the daily check-out sheets and/or accounting records
- Examining computerized audit logs for unusual receipt transactions

All these processes should be monitored (see Component 5) on an ongoing basis. Monitoring may involve staff employees, management, internal audit, outside contractors, or some type of computer analytics or computer application controls. In addition, establishing an Internal Audit Function for the entity is a good overall internal control for receipting.

Example 2 – Cash Disbursements:
The following disbursement transactions pose various types of risks. The list is not intended to be all-inclusive. Establishing an Internal Audit Function for the entity is a good overall internal control for disbursements. Control activities should be implemented to mitigate risks related to the different types of disbursement transactions:

Disbursements/Expenditures	Control Activity Considerations
All Purchases	Requisitions, Purchase Orders, Dual Signature on Checks, Controlling the Signature Plate, Obtaining Receiving Documentation, Review documentation before Issuing Check, Adequate Segregation of Duties, Performing Bank Reconciliations Monthly, Examining Cancelled Checks and Outstanding Checks, Employee Dishonesty Insurance, Computer Analytics Software, etc. , Monitor the Activity Controls Effectiveness
Heavy Equipment Purchases	Accept Bids, Utilize Bid Specifications, Establish Conflict of Interest Policies, Establish a Committee to Oversee the Process.
P-Card and Credit Purchases	Establish a Use and Abuse Policy, Control the number of and access to P-Cards and Credit Cards, Assign Purchase Limit, Assign Purchase Restrictions (e.g. for Certain Stores or for Travel Only), Receive an Itemized Statement by Department, Employee, etc., Review transactions regularly.
Travel	Develop a Travel Policy (Rates, What is Covered, Lines of Approval Authority, Abuse, Etc.), Follow Controls at All Purchases Above, Monitor Compliance

	with the Policy.
Cell Phones Mobile Devices Monthly Charges	Establish a Use and Abuse Policy, Control the Number of and Access to Cell Phones or other Mobile Devices, Assign Airtime/Minutes and Data Usage Limits, Assign Use Restrictions (e.g. for Business Use Only), Receive an Itemized Statement by Department, Employee, etc., Review transactions regularly.
Investments	Develop an Investment Policy, Establish an Investment Committee.
Derivatives	Follow the Comptroller's Policies, Develop a Derivative Policy, Establish an Oversight and Advisory Committee, Establish Conflict of Interest Policies, Have the Transaction Approved by the Governing Body.
Information Technology Purchases	Major I/T Purchases Should Involve the Finance and I/T Departments as well as affected Department Heads, the Desired Information and Output Requirements Must be Very Clear, Should use Bids, RFPs or Other Formal Process, Utilize Bid Specifications, Establish Conflict of Interest Policies, Establish a Committee to Oversee the Process.
Insurance	Develop an Insurance Policy, Consider an Insurance Committee, Establish Conflict of Interest Policies, Should use Bids, RFPs or Other Formal Process.
Major Building Construction	Must be Approved by Governing Body, Develop a Policy (i.e. Type of Contracts, Type of Involvement by Outside Engineers, Architects, Construction Managers, Insurance Requirements, Etc.), Should use Bids, RFPs or Other Formal Process, Utilize Bid Specifications, Establish Conflict of Interest Policies, Establish a Committee to Oversee the Process.
Inventory (Supplies, Gasoline, Parts, Etc.)	Maintain Perpetual Inventory Records, Limit Access to Inventory, Maintain Usage Records by Employee, Perform Physical Inventory Counts and Reconcile the Amount to Inventory Records.

2. ***Management should design the entity's computerized information system and related control activities to achieve objectives and respond to risks.***

This involves:
Design of the entity's information system
Design of appropriate types of control activities
Design of information technology structure
Design of security management
Design of information technology acquisition, development, and maintenance

Application:
Develop and periodically review and update guidelines for information technology documenting:

- The types of computerized information required to be compiled to meet the government's objectives
- The computer application controls necessary to ensure that information is valid, complete, and accurate
- The general computer controls addressing security management procedures, contingency plans, configuration, logical and physical access
- Information technology infrastructure needs and the controls needed to ensure that adequate resources are available to meet the reporting needs (e.g storage capacity)
- The external and internal security risks and the controls necessary to limit exposure to unauthorized access, corruption of data, or other misappropriation of information (e.g. personally identifiable information)
- Controls necessary to ensure that technology acquisition, development and maintenance activities are authorized, necessary, and properly integrated throughout the organization

Example:
The local government has determined that one of its objectives is to improve the quality and level of services by maximizing the use of grant resources to provide services. As a part of the roll-out of a recent information system upgrade related to grants administration, management has identified certain risks that were previously not addressed. This example addresses the controls to be implemented to ensure that the information system will meet this objective.

A management level employee will periodically meet with all department heads to:

- Evaluate the types of grants available and whether applying for the grants will enhance or expand current services
- Review any grant reporting requirements or changes to current grant programs that might impact the software and hardware maintenance schedule
- Assess and prioritize enhancements to meet any changes or additional needs in reporting requirements
- Assess the adequacy of general computer processes and controls
- Assess staffing and training requirements

- Assess internal and external risks

Grant Controls:

- Grant applications will be processed through a central grants processing division
- Only designated individuals, approved by the department head, will be given access to enter contracts in the computerized accounting system
- Expenditures related to a grant contract can't be entered until a contract has been approved
- Information technology entry will be restricted by logins and passwords that are changed periodically. Information technology personnel who have access to the logins and passwords of accounting staff should be restricted. Some entities may also need to restrict physical equipment and server access
- Computer application and systems training schedules will be completed by all department heads by the first of each fiscal year and updated for any significant changes throughout the year.
- Grant administration employees will be trained on new software annually

3. ***Management should implement control activities through policies.***

This involves:
Documentation of responsibilities through policies
Periodic review of control activities

Application:
Management will develop and periodically review and update a policies manual that documents:

- The overall general policies for the local entity that address the broad expectations (objectives and related risks, control activity design, implementation and operating effectiveness) of management and the responsibilities for each unit (office, division, department or other organizational segment) of the local entity
- Management's plan for monitoring departmental policies, procedures, and control activities developed by each unit to implement the general policies
- The means by which policies, procedures and control activities will be communicated to staff
- Management will ensure that each unit document policies, day-to-day procedures, and control activities to implement management's policies

Example:
The local government has determined that one of its policies is to have accurate, complete and timely financial reporting throughout the year and at year end in compliance with local and state statutes and management's goals. To accomplish this, related risks will need to be considered and control activities will have to be developed by all departments in the local entity.

To streamline this example, the focus will be on one objective in the accounting office – closing the books of account within sixty (60) days following the fiscal year end as required by state statute.

The example assumes that objectives and related risks, and control activity design implementation and operating effectiveness are in place in all other departments that have revenues, receivables, purchasing, payroll, payables, debt, capital asset, budgetary, and other financial activities.

Financial records are maintained on a cash basis throughout the year. Monthly and quarterly reports are not adjusted for accruals and other year-end only entries. The focus here is on the unique year-end closing entries.

Some of the main risks to consider when designing control activities for the year-end close out are as follows:

- Cash and investments may not be recorded or valued properly.
- Material year-end receivables/revenues may not be recorded.
- Material year-end payables/expenses/expenditures may not be recorded.
- Estimates such as allowance accounts may be inaccurate. What documentation exists to prove the estimate?
- Capital asset and depreciation accounts may not include material additions and disposals to capital assets.
- Material debt activity may not be recorded. Have debt proceeds been recorded gross or net of issuance costs?
- Material payroll activity, including pension liabilities, deferrals, and expense, may not be recorded.
- Net position may not be properly classified.
- Significant difficulties (complex new accounting standards, litigation, etc.), delays (grants, construction conflicts, pension data not available, etc.) or problems (computer system problems, key personnel leave, etc.) may be encountered causing data to be unavailable or to otherwise impede closing the books.
- Who is assigned to gather this information?
- Who is assigned to review the posting of year-end entries and conversion of balances from modified accrual basis to full accrual basis?
- Who is responsible for determining compliance with generally accepted accounting principles (GAAP)?
- What prior-year audit adjustments were considered necessary by auditors?
- Other related risks.

Control activities and procedures within the accounting department to address risks and ensure that the books are closed within sixty (60) days following the fiscal year-end include:

At the beginning of every fiscal year, immediately following the closing of the prior-year books of account, the accounting department, in coordination with all other departments, will:

- Review the prior year closing process and identify any difficulties, weaknesses or additional risks that were encountered.
- Review any matters identified with management to determine whether any changes are required and, if so, oversee the development and design of those changes.
- Review any new accounting standards and any accounting standards that are being developed that may be issued that will impact the upcoming year end closing.
- Consider the effects of new laws such as for new taxes.
- Set a tentative timeline for the upcoming year-end closing.
- Communicate the plan to all department heads for dissemination to employees whose work will be impacted by the plan.
- Revisit the plan with all departments near the end of the year.

COMPONENT 4

INFORMATION AND COMMUNICATION

GAO Green Book Principles 13 through 15

Management is responsible for developing and providing internal and external information. This information supports the internal control system and validates its existence. There are three (3) principles related to information and communication.

1. ***Management should use quality information to achieve the entity's objectives.***

   <u>This involves:</u>
   Identifying the entity's information requirements
   Gathering relevant data from reliable sources
   Processing data into quality information

   <u>Application:</u>
   Management should, on a regular basis:
   - Review and document the information requirements to achieve key objectives and address the risks of the government
   - Review and document changes that occur in the local government's objectives and the related changes in information requirements
   - Identify and evaluate the reliability and timeliness of relevant data from both internal and external sources
   - Review and evaluate whether data has been processed into quality information that allows management to make informed decisions and evaluate whether the local government is achieving its objectives

   <u>Examples:</u>

   <u>Example 1:</u>
   Management has determined that one of its objectives is to provide accurate and timely financial statements to the governing body and to the entity's citizens on an annual basis prepared in accordance with generally accepted accounting principles (GAAP). This includes a balance sheet and statement of operations that includes budgetary comparisons for each governmental fund. As you read through the abbreviated list below, ask yourself, "Where do I get this information?" And "How do I know it is accurate and reliable?" Some of the more vital information requirements are as follows:

a. What accounting principles should be followed to properly record the information
b. The amount of cash and investments at the end of the year
c. The amount of receivables and payables at the end of the year
d. The amount of revenue for the month and year-to-date
e. The amount of expenditures for the month and year-to-date
f. The original budget approved by the governing body
g. Reports from other offices or departments such as the County Trustee or Utility Fund
h. The amount of fund balance restrictions, commitments, and assignments at the end of the month
i. For enterprise funds, information about equipment costs, depreciation, and long-term debt
j. What journal entries are necessary, who approves them, and for what amounts

Accurate reliable financial statements cannot be prepared without the above information. Each piece of information fits together like a large jigsaw puzzle. Therefore, it follows, that each piece of the puzzle must also be accurate and reliable. This cannot happen unless internal controls are properly designed and operating effectively. For example, cash must be reconciled with bank statements. Accounts receivable must be reconciled with the detailed receivable ledger, the control ledger, and the general ledger. Payables are similar. Likewise, total monthly revenues and expenditures must be accumulated from some reliable source. The original budget must to be posted to accounting records and someone must determine if it was the actual budget approved by the governing body? Reports from other offices must be received and recorded, but how do I know these records are correct? The amount of fund balance that is restricted must be tracked on some record. Finally, all this information must be assembled and presented in the format of a formal financial statement. This is certainly not all that is required, but it does give the reader a hint of the types of information and internal controls necessary to prepare financial statements.

Again, the looming question is, how do I know any of the underlying information is accurate and reliable so that the entity can use it to present financial statements? The answer is, the entity doesn't know unless there are properly designed internal controls that are operating effectively for each piece of information. These controls usually fall into the category of ***Control Activities,*** which are discussed under Component 3 in this manual.

<u>Example 2:</u>
Management has determined that one of its objectives is to provide quality fire and police protection to the government's citizens. Management has determined that the information requirements needed to assess the quality of these services are:

a. Response times

b. Average number of weekly calls broken down into three, eight-hour blocks of time
c. Payroll data for the entity and comparable salary and benefits package comparisons from other entities to assist in attracting quality personnel
d. Equipment and vehicle status, future and current needs and replacement costs

Relevant data for each of the information requirements can be obtained from both internal and external sources. E911 records and dispatch records will provide data regarding response times and number of calls. The Comptroller's Transparency and Accountability for Governments in Tennessee (TAG) website will be used to find the payroll and fringe costs for other comparable local governments, and when TAG information is not available, the on-line audit reports will be utilized to glean information on those costs. Internal records regarding equipment repairs and maintenance, both the type of repair and the cost, will be compiled to evaluate equipment status, and searches on the internet will be used to evaluate the potential costs of equipment.

How does management know that dispatch records and repair and maintenance records are useful for making management decisions? Unless internal controls are in place to ensure the accuracy and reliability of the required information, management will be limited in its ability to make judgments about the quality of service provided.

2. ***Management should internally communicate the necessary quality information to achieve the entity's objectives.***

<u>This involves:</u>
Intentional communication throughout the entity
Deciding appropriate methods of communication

<u>Application:</u>
- Management clearly defines the lines of communication through policy manuals and organization charts
- Management has communicated the types of information required to achieve objectives and address risks
- All internal control documents and related reports will be available to all staff in an appropriate method based on confidentially and relevance to job responsibilities
- The appropriate information delivery system has been determined (e.g. email, written memo, staff meetings, etc.) for changes and updates
- Reports containing personally identifiable information or other protected or confidential information will be made available through communication methods that restrict internal and external access
- Annual staff training meetings and new employee orientation, with relevant handouts and manuals, will be used to reinforce memo, email, intranet, and restricted communications

Example:
The entity has been evaluating various possibilities for increasing its revenues and has decided on a long-term project with several phases. The first phase of the project involves expanding utility services. The expansion is intended to enhance industrial development by increasing service capacity. As a result, several strategic objectives have been modified. The modifications impact staffing, reporting, related internal controls, and other matters. Communication is going to be complicated because at least two older employees will be allowed to telecommute and two new employees will be hired as part of the first phase of the project.

The oversight board has directed management to incorporate the changes in the policies and procedures, develop several new reports, and enhance the communication capabilities of the entity.

Management is working with information technology staff to utilize current technologies for remotely accessing the entity's network. In addition, electronic messaging and teleconferencing capabilities are being enhanced to facilitate overall communication and training participation at remote meeting sites.

Policies, procedures, and internal control design and activities are being updated to address the risks inherent to a large new construction project and to enhance remote communication.

3. ***Management should externally communicate the necessary quality information to achieve the entity's objectives.***

This involves:
Intentional communication with external parties
Deciding appropriate methods of communication

Application:
Management should develop policies and procedures for:
- Communicating with external parties. Some examples include providing financial statements or other information to:
  - General public
  - Auditors
  - Federal grant agencies, SEC through the Electronic Municipal Market Access system (EMMA)
  - Bond rating companies, prospective bond purchasers, and underwriters
  - Vendors and contractors
  - Insurance companies
  - Law enforcement officials
  - News media
  - Individuals or public interest groups based on public information requests

- Evaluating the reliability of information provided to and received from external parties
- Ensuring that only authorized individuals provide information to external parties
- Ensuring that restricted information is provided only to authorized external parties
- Redacting of information when requested under the open records statutes

In summary, it is vitally important that information communicated to outside parties be accurate. This involves many different layers of internal controls including the control environment, the risk assessment process, and control activities. Before information is released to an outside party, management should be confident based on its internal policies and procedures, the information is accurate. The credibility of the entity, its governing body, and public officials is at stake whenever information is released to outside parties.

Example:
The local newspaper has requested information regarding salaries/wages for all of the local government's employees.

Management has determined that all communications with the media will be channeled through a single individual to ensure that information is accurate and consistent with legal and office requirements and the request has been forwarded to that individual.

There is some question regarding the information that is being requested, that is, does the newspaper want base salary and wage amounts or total payments, including overtime, for a particular period. The responsible individual has contacted the newspaper to clarify the request.

The local newspaper responds that they want the current authorized pay rates and the total amount of payments for the most recent calendar year. The request is forwarded to accounting to extract the requested information.

The accounting system generates reports that include the information being requested. However, those reports include restricted information. The report will need to be reformatted to eliminate the restricted information. The modified report is submitted to the authorized individual in the local government who submits the information to the local newspaper.

COMPONENT 5

MONITORING

GAO Green Book Principles 16 and 17

Things change - the Operating Environment, Laws, Accounting Principles, Technology, Resources, and People, etc. For this reason, internal control policies and procedures must constantly be monitored and improved or updated. There are two (2) principles related to monitoring.

1. ***Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.***

<u>This involves:</u>
Determining issues and deficiencies in the current internal control system
Testing the internal control system against the intended design (monitoring)
Evaluating the results of the monitoring tests and making necessary improvements or updates

<u>Application:</u>
Management should:

- Evaluate and document the current state of the internal control system and document the differences between the criteria of the design and the current condition of internal control, for purposes of establishing a baseline
- Determine whether to change the design of internal control or implement corrective actions to improve the operating effectiveness of internal control for differences that exist
- Monitor internal control through built in monitoring activities and periodic separate evaluations and document the results
- Evaluate differences to determine if (1) changes in internal control have occurred but have not been documented, (2) internal control has not been properly implemented, or (3) internal control design changes are needed

<u>Example:</u>
Management has adopted a policy requiring ongoing monitoring activities in key areas of internal control such as purchasing. By reviewing the results, management is able to determine where differences exist between the design and actual practice. Those results can then be evaluated to determine a course of action.

Over the last three months, based on tests (i.e. monitoring) of internal controls over purchasing documentation, management noted a marked increase in the number of invoices submitted for approval that included sales tax charges from which the government is exempt. In addition, purchase orders have not been attached, or did not have the proper signatures authorizing purchases in several instances.

In evaluating the control structure and the control activities, management noted that many of the weaknesses were clustered in two departments. Those departments had experienced turnover in employees due to the retirement of two key employees as well as normal turnover in two other positions. In addition, two processes that had been manual processes in the past had been automated and the internal control documentation had not been updated for those changes. One of the individuals that been hired had significant experience in the private sector but no experience in government operations. The cumulative effect of all of these changes resulted in internal control execution deficiencies. The current design of the controls was deemed to be appropriate.

Corrective action proposed includes: (1) update internal control policies and procedures to reflect the current control design, (2) provide additional training and coaching for new employees, (3) improve succession plans for the departure of key employees, and (4) improve the process for ensuring documents are updated when changes are made to the internal control design.

2. ***Management should remediate identified internal control deficiencies on a timely basis.***

<u>This involves:</u>
Reporting internal control issues and deficiencies to the responsible management representative
Management should document reported internal control issues and deficiencies and evaluate each issue for corrective action
Actions should be taken to correct audit findings and other issues and deficiencies. This may require action by the governing body or other oversight body.

<u>Application:</u>
Management should:

- Adopt policies regarding ongoing monitoring processes and the method and timing of reporting issues and deficiencies to a designated individual
- Document the evaluation of issues noted during ongoing and periodic monitoring
- Propose a corrective action plan and implement the corrective action on a timely basis

Example:
Continuing with the example at principle 1 above, monitoring of internal controls over purchasing was completed by the finance director's staff and the results documented and submitted to the finance director for review. Assuming the results do not require the governing body's or other oversight body's approval, the summary of results should include:

The scope of the review, the number and types of issues and deficiencies noted and the proposed corrective actions. The senior responsible official (i.e. equivalent to the mayor, finance director, or city manager) added a timeline for the corrective action plan and approved the plan. The plan was submitted to the department heads for implementation.