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December 21, 2004

MEMORANDUM TO THE CHIEF FINANCIAL OFFICERS, CHIEF OPERATION OFFICERS, CHIEF INFORMATION OFFICERS, AND PROGRAM MANAGERS

FROM: Linda M. Springer
Controller 

President's Budget

- FY 2007 Budget Supplementals, Budget Amendments, and Releases

SUBJECT: Revisions to OMB Circular A-123, Management's Responsibility for Internal Control

Management

- President's Management Agenda Results.gov & Scorecards
- Program Performance/PART
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OMB Circular No. A-123 defines management's responsibility for internal control in Federal agencies. A re-examination of the existing internal control requirements for Federal agencies was initiated in light of the new internal control requirements for publicly-traded companies contained in the Sarbanes-Oxley Act of 2002. Circular A-123 and the statute it implements, the Federal Managers' Financial Integrity Act of 1982, are at the center of the existing Federal requirements to improve internal control.

This circular reflects policy recommendations developed by a joint committee of representatives from the Chief Financial Officer Council (CFOC) and the President's Council on Integrity and Efficiency (PCIE). The policy changes in this circular are intended to strengthen the requirements for conducting management's assessment of internal control over financial reporting. The circular also emphasizes the need for agencies to integrate and coordinate internal control assessments with other internal control-related activities.

The revised circular is effective for FY 2006. Agencies should take steps in FY 2005 to prepare for its implementation. OMB plans to continue to work closely with the CFOC and the PCIE to provide further implementation guidance.

Information & Regulatory Affairs

- Regulatory Matters
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- Information Policy, E-gov & IT



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December 21, 2004

CIRCULAR NO. A-123
Revised

Legislative Information

- Statements of Admin. Policy

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

Agency Information

SUBJECT: Management's Responsibility for Internal Control

1. **Purpose.** This Circular provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal control. The attachment to this Circular defines management's responsibilities related to internal control and the process for assessing internal control effectiveness along with a summary of the significant changes. The Circular provides updated internal control standards and new specific requirements for conducting management's assessment of the effectiveness of internal control over financial reporting (Appendix A). This Circular emphasizes the need for integrated and coordinated internal control assessments that synchronize all internal control-related activities.

This revision to the Circular will become effective in Fiscal Year 2006 and supersede all previous versions. In the interim, OMB Circular No. A-123, "Management Accountability and Control," revised, June 21, 1995 should continue to be followed.

2. **Authority.** The Circular is issued under the authority of the Federal Managers' Financial Integrity Act of 1982 as codified in 31 U.S.C. 3512.

3. **Policy.** Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Management shall consistently apply the internal control standards to meet each of the internal control objectives and to assess internal control effectiveness. When assessing the effectiveness of internal control over financial reporting and compliance with financial-related laws and regulations, management must follow the assessment process contained in Appendix A. Annually, management must provide assurances on internal control in its Performance and Accountability Report, including a separate assurance on internal control over financial reporting, along with a report on identified material weaknesses and corrective actions.

4. **Actions Required.** Agencies and individual Federal managers must take systematic and proactive measures to (i) develop and implement appropriate, cost-effective internal control for results-oriented management; (ii) assess the adequacy of internal control in Federal programs and operations; (iii) separately assess and document internal control over financial reporting consistent with the process defined in Appendix A (iv) identify needed improvements; (v) take corresponding corrective action; and (vi) report annually on internal control through management assurance statements.

5. **Effective Date.** This Circular is effective beginning with Fiscal Year 2006.

6. **Applicability.** This Circular is applicable to each executive agency, with the exception of the requirements in the appendix. The requirements of Appendix A are applicable to the 24 CFO Act agencies.

7. **Inquiries.** Further information concerning this Circular may be obtained from the Financial Standards and Grants Branch, Office of Federal Financial Management, Office of Management and Budget, Washington, DC 20503, 202/395-3993.

8. **Copies.** Copies of this Circular may be obtained from www.omb.gov.



Joshua B. Bolten
Director

Significant Revisions to OMB Circular A-123

Section	Revision to A-123	Purpose of Revision
Transmittal of Circular	Changed title from OMB Circular A-123, <i>Management Accountability and Control</i> to OMB Circular A-123, <i>Management's Responsibility for Internal Control</i>	Title changed to align better with the focus of the circular and current terminology.
Throughout Circular	Changed terminology from "management controls" to "internal control"	To better align with currently accepted standards for internal control and current terminology. The terms are intended to be synonymous.
Section II. Standards	Realigned section on the standards for internal control using the following categories: control environment, risk assessment, control activities, information and communication, and monitoring.	To better align with currently accepted standards for internal control.
Section III. Integrated Internal Control Framework	Provided a separate section on an integrated internal control framework. Provided a listing of statutes to consider when assessing internal control.	To highlight current legislative and regulatory requirements that should be coordinated and considered when assessing the effectiveness of internal control.
Section IV.B. Identification of Deficiencies	Introduced reportable condition as a category of deficiency.	To better align with current governmental terminology.
Section VI.A. Annual Assurance	Require agencies subject to the CFO Act to include the FMFIA annual report	To consolidate assurance statements in one place within the PAR (Section

Statements	in the PAR, under the heading “Management Assurances” and submit to OMB 45 days from the end of the fiscal year.	2, Section 4, and internal control over financial reporting). To accelerate the due date of the FMFIA reports to be consistent with the due date for the PAR.
Section VI.B. Reporting Pursuant to Section 2	Introduced a new assurance statement on the effectiveness of internal control over financial reporting. This statement will be a subset of the overall FMFIA assurance statement.	To emphasize management’s responsibility for assessing and documenting internal control over financial reporting. To ensure Congress and the public that the Federal Government is committed to safeguarding its assets and providing reliable financial information.
Section VI. Reporting on Internal Control	Included a summary chart of definitions and reporting requirements for deficiency, reportable condition, material weakness, and nonconformance.	To provide a concise summary of reporting definitions.
Appendix A	To specifically address assessing, documenting, and reporting on the effectiveness of internal control over financial reporting.	To ensure Congress and the public that the Federal Government is committed to safeguarding its assets and providing reliable financial information.

**New Requirements in Appendix A –
Internal Control over Financial Reporting**

New Section	New Requirement
Transmittal of Circular	Requires the 24 CFO Act agencies to comply with Appendix A. .
Section II. Scope	Defines the scope of assessing and documenting internal control over financial reporting to include the annual financial

	statements and other significant internal or external financial reports and compliance with laws and regulations that pertain to those financial reports
Section II.C. Planning Materiality	Defines materiality for the purposes of assessing and documenting internal control over financial reporting.
Section III.A. Establish a Senior Assessment Team	Recommends the establishment of a senior assessment team, which at a minimum should oversee the assessment process.
Section III.B-E. Assessing Internal Control over Financial Reporting	Defines a process for assessing internal control over financial reporting at the entity level as well as at the process, transaction, or application level.
Section IV. Documentation	A. Requires that the controls over financial reporting be documented. B. Requires that the assessment process of the controls over financial reporting be documented.
Section V. Management’s Assessment of Internal Control over Financial Reporting	Requires the assurance statement assert to the effectiveness of internal control “as of June 30.” The assurance statement and corrective actions, if applicable, will be submitted in the PAR no later than 45 days after the end of each fiscal year.
Section V. Management’s Assessment of Internal Control over Financial Reporting	Provides a sample assurance statement on the effectiveness of internal control over financial reporting.
Section V.A. Agencies Obtaining Audit Opinions on Internal Control	Agencies electing to receive a separate audit opinion on internal control over financial reporting may adjust the “as of” reporting date of June 30 to align better with the “as of” date of the audit opinion. This circular does not require a separate audit.
Section VI. Correcting Material Weaknesses in Internal Control over Financial Reporting	Provides a non-compliance clause that permits OMB to require an agency to obtain an audit opinion over the internal controls over financial reporting if the agreed upon

deadlines for corrective actions are continuously not met.
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I. INTRODUCTION

Management has a fundamental responsibility to develop and maintain effective internal control. The proper stewardship of Federal resources is an essential responsibility of agency managers and staff. Federal employees must ensure that Federal programs operate and Federal resources are used efficiently and effectively to achieve desired objectives. Programs must operate and resources must be used consistent with agency missions, in compliance with laws and regulations, and with minimal potential for waste, fraud, and mismanagement.

Management is responsible for developing and maintaining effective internal control. Effective internal control provides assurance that significant weaknesses in the design or operation of internal control, that could adversely affect the agency's ability to meet its objectives, would be prevented or detected in a timely manner.

Internal Control -- organization, policies, and procedures -- are tools to help program and financial managers achieve results and safeguard the integrity of their programs. This Circular provides guidance on using the range of tools at the disposal of agency managers to achieve desired program results and meet the requirements of the Federal Managers' Financial Integrity Act (FMFIA) of 1982. The FMFIA encompasses accounting and administrative controls. Such controls include program, operational, and administrative areas as well as accounting and financial management.

The importance of internal control is addressed in many statutes and executive documents. The FMFIA establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that: "(i) obligations and costs are in compliance with applicable law; (ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use or misappropriation; and (iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets."¹ In addition, the agency head annually must evaluate and report on the control and financial systems that protect the integrity of Federal programs (Section 2 and Section 4 of FMFIA respectively). The three objectives of internal control are to ensure the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The safeguarding of assets is a subset of all of these objectives.

Instead of considering internal control as an isolated management tool, agencies should integrate their efforts to meet the requirements of the FMFIA with other efforts to improve effectiveness and accountability. Thus, internal control should be an integral part of the entire cycle of planning, budgeting, management, accounting, and auditing. It should support the effectiveness and the integrity of every step of the process and provide continual feedback to management.

Federal managers must carefully consider the appropriate balance between controls and risk in their programs and operations. Too many controls can result in inefficient and ineffective government; agency managers must ensure an appropriate balance between the strength of controls and the relative risk associated with particular programs and operations. The benefits of controls should outweigh the cost. Agencies should consider both qualitative and quantitative factors when analyzing costs against benefits.

A. Agency Implementation. Internal control guarantees neither the success of agency programs, nor the absence of waste, fraud, and mismanagement, but is a means of managing the risk associated with Federal programs and operations. Managers should define the control environment (e.g., programs, operations, or financial reporting) and then perform risk assessments to identify the most significant areas within that environment in which to place or enhance internal control. The risk assessment is a critical step in the process to determine the extent of controls. Once significant areas have been identified, control activities should be implemented. Continuous monitoring and testing should help to identify poorly designed or ineffective controls and should be reported upon periodically. Management is then responsible for redesigning or improving upon those controls. Management is also responsible for communicating the objectives of internal control and ensuring the organization is committed to sustaining an effective internal control environment.

Appropriate internal control should be integrated into each system established by agency management to direct and guide its operations. As stated earlier in this document, internal control applies to program, operational, and administrative areas as well as accounting and financial management.

Generally, identifying and implementing the specific procedures necessary to ensure effective internal control, and determining how to assess the effectiveness of those controls, is left to the discretion of the agency head. While the procedures may vary from agency to agency, management should have a clear, organized strategy with well-defined documentation processes that contain an audit trail, verifiable results, and specify document retention periods so that someone not connected with the procedures can understand the assessment process.

To ensure senior management involvement, many agencies have established their own senior management council, often chaired by the agency's lead management official, to address management accountability and related issues within the broader context of agency operations. Relevant issues for such a council include ensuring the agency's commitment to an appropriate system of internal control; actively overseeing the process of assessing internal controls, including non-financial as well as financial reporting objectives; recommending to the agency head which control deficiencies are material to disclose in the annual FMFIA report; and providing input for the level and priority of resource needs to correct these deficiencies. (See also Section IV.C. *Role of a Senior Management Council.*)

II. STANDARDS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.²

Internal control, in the broadest sense, includes the plan of organization, methods and procedures adopted by management to meet its goals. Internal control includes processes for planning, organizing, directing, controlling, and reporting on agency operations.

The three objectives of internal control are:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

The safeguarding of assets is a subset of all of these objectives. Internal control should be designed to provide reasonable assurance regarding prevention of or prompt detection of unauthorized acquisition, use or disposition of assets.

Management is responsible for developing and maintaining internal control activities that comply with the following standards to meet the above objectives:

- Control Environment,
- Risk Assessment,
- Control Activities,
- Information and Communications, and
- Monitoring

A. Control Environment

The control environment is the organizational structure and culture created by management and employees to sustain organizational support for effective internal control. When designing, evaluating or modifying the organizational structure, management must clearly demonstrate its commitment to competence in the workplace. Within the organizational structure, management must clearly: define areas of authority and responsibility; appropriately delegate the authority and responsibility throughout the agency; establish a suitable hierarchy for reporting; support appropriate human capital policies for hiring, training, evaluating, counseling, advancing, compensating and disciplining personnel; and uphold the need for personnel to possess and maintain the proper knowledge and skills to perform their assigned duties as well as understand the importance of maintaining effective internal control within the organization.

The organizational culture is also crucial within this standard. The culture should be defined by management's leadership in setting values of integrity and ethical behavior but is also affected by the relationship between the organization and central oversight agencies and Congress. Management's philosophy and operational style will set the tone within the organization. Management's commitment to establishing and maintaining effective internal control should cascade down and permeate the organization's control environment which will aid in the successful implementation of internal control systems.

B. Risk Assessment

Management should identify internal and external risks that may prevent the organization from meeting its objectives. When identifying risks, management should take into account relevant interactions within the organization as well as with outside organizations. Management should also consider previous findings; e.g., auditor identified, internal management reviews, or noncompliance with laws and regulations when identifying risks. Identified risks should then be analyzed for their potential effect or impact on the agency.

C. Control Activities

Control activities include policies, procedures and mechanisms in place to help ensure that agency objectives are met. Several examples include: proper segregation of duties (separate personnel with authority to authorize a transaction, process the transaction, and review the transaction); physical controls over assets (limited access to inventories or equipment); proper authorization; and appropriate documentation and access to that documentation.

Internal control also needs to be in place over information systems – general and application control. General control applies to all information systems such as the mainframe, network and end-user environments, and includes agency-wide security program planning, management, control over data center operations, system software acquisition and maintenance. Application control should be designed to ensure that transactions are properly authorized and processed accurately and that the data is valid and complete. Controls should be established at an application's interfaces to verify inputs and outputs, such as edit checks. General and application control over information systems are interrelated, both are needed to ensure complete and accurate information processing. Due to the rapid changes in information technology, controls must also adjust to remain effective.

D. Information and Communications

Information should be communicated to relevant personnel at all levels within an organization. The information should be relevant, reliable, and timely. It is also crucial that an agency communicate with outside organizations as well, whether providing information or receiving it. Examples include: receiving updated guidance from central oversight agencies; management communicating requirements to the operational staff; operational staff communicating with the information systems staff to modify application software to extract data requested in the guidance.

E. Monitoring

Monitoring the effectiveness of internal control should occur in the normal course of business. In addition, periodic reviews, reconciliations or comparisons of data should be included as part of the regular assigned duties of personnel. Periodic assessments should be integrated as part of management's continuous monitoring of internal control, which should be ingrained in the agency's operations. If an effective continuous monitoring program is in place, it can level the resources needed to maintain effective internal controls throughout the year.

Deficiencies found in internal control should be reported to the appropriate personnel and management responsible for that area. Deficiencies identified, whether through internal review or by an external audit, should be evaluated and corrected. A systematic process should be in place for addressing deficiencies.

III. INTEGRATED INTERNAL CONTROL FRAMEWORK

Federal agencies are subject to numerous legislative and regulatory requirements that promote and support effective internal control. Effective internal control is a key factor in achieving agency missions and program results through improved accountability. Identifying internal control weaknesses and taking related corrective actions are critically important to creating and maintaining a strong internal control infrastructure that supports the achievement of agency objectives. Recent government-wide initiatives have been implemented to improve program management, as well as financial management, including tracking corrective actions for material weaknesses in internal control related to financial reporting, imposing accelerated reporting due dates for more timely financial information, and assessing the effectiveness and efficiency of program operations using the Program Assessment Rating Tool (PART). Activities conducted as part of these initiatives support an agency's overall internal control framework. Statutory requirements that should also be considered as part of an agency's internal control framework include:

Federal Managers Financial Integrity Act of 1982 (FMFIA)

The FMFIA requires agencies to establish and maintain internal control. The agency head must annually evaluate and report on the control and financial systems that protect the integrity of Federal programs; Section 2 and Section 4 respectively. The requirements of FMFIA serve as an umbrella under which other reviews, evaluations and audits should be coordinated and considered to support management's assertion about the effectiveness of internal control over operations, financial reporting, and compliance with laws and regulations.

Government Performance and Results Act (GPRA)

To support results-oriented management, GPRA requires agencies to develop strategic plans, set performance goals, and report annually on actual performance compared to goals. With the implementation of this legislation, these plans and goals are integrated into (i) the budget process, (ii) the operational management of agencies and programs, and (iii) accountability reporting to the public on performance results, and on the integrity, efficiency, and effectiveness with which they are achieved. Similarly, the PART's primary purpose is to assess program effectiveness and improve program performance. The PART has also become an integral part of the budget process when making funding resource allocations or decisions.

Chief Financial Officers Act, as amended (CFO Act)

The CFO Act requires agencies to both establish and assess internal control related to financial reporting. The Act requires the preparation and audit of financial statements. In this process, auditors report on internal control and compliance with laws and regulations related to financial reporting. Therefore, the agencies covered by the Act have a clear opportunity to improve internal control over their financial activities, and to evaluate the controls that are in place. The Accountability of Tax Dollars Act of 2002 amended the CFO Act to expand the types of Federal agencies that are required to prepare audited financial statements.

Meeting the accelerated financial statement reporting due date also provides incentive for agencies to have added discipline and effective internal control to routinely produce reliable financial information. Deficiencies in internal control need to be mitigated to ensure timely and accurate financial information.

Inspector General Act of 1978, as amended (IG Act)

The IG Act provides for independent reviews of agency programs and operations. IGs are required to submit semiannual reports to Congress on significant abuses and deficiencies identified during the reviews and the recommended actions to correct those deficiencies. IGs and/or external auditors are required by the *Government Auditing Standards*³ and OMB Bulletin No. 01-02, *Audit Requirements of Federal Financial Statements, as amended*⁴ to report material weaknesses in internal control related to financial reporting and noncompliance with laws and regulations as part of the financial statement audit. Auditors also provide recommendations for correcting the material weaknesses. Agency managers, who are required by the IG Act to follow up on audit recommendations, should use these reviews to identify and correct problems resulting from inadequate or poorly designed controls, and to build appropriate controls into new programs. Audit work planned by the IG should be coordinated with management's assessment requirements to ensure cost effectiveness and avoid duplication.

Federal Financial Management Improvement Act of 1996 (FFMIA)

The FFMIA requires agencies to have financial management systems that substantially comply with the Federal financial management systems requirements, standards promulgated by the Federal Accounting Standards Advisory Board (FASAB), and the U.S. Standard General Ledger (USSGL) at the transaction level. Financial management systems shall have general and application controls in place in order to support management decisions by providing timely and reliable data. The agency head shall make a determination annually about whether the agency's financial management systems substantially comply with the FFMIA. If the systems are found not to be compliant, management shall develop a remediation plan to bring those systems into substantial compliance. Management shall determine whether non-compliances with FFMIA should also be reported as non-conformances with Section 4 of FFMIA.

Federal Information Security Management Act of 2002 (FISMA)

The FISMA provides, "...a comprehensive framework for ensuring the effectiveness of information security controls over information resources that support Federal operations and assets..." Agencies are required to provide information security controls proportionate with the risk and potential harm of not having those controls in place. Agency heads are required to annually report on the effectiveness of the agencies' security programs. "Significant deficiencies" found under FISMA must also be reported as material weaknesses under FFMIA.

Improper Payments Information Act of 2002 (IPIA)

The IPIA requires agencies to review and, "...identify programs and activities that may be susceptible to significant improper payments." Agencies must annually submit estimates of improper payments, corrective actions to reduce the improper payments, and statements as to

whether its current information systems and infrastructure can support the effort to reduce improper payments. The nature and incidence of improper payments shall be considered when assessing the effectiveness of internal control.

Single Audit Act, as amended

The Single Audit Act, as amended requires financial statement audits of non-Federal entities that receive or administer grant awards of Federal monies. The financial statement audits include testing the effectiveness of internal control and determining whether the award monies have been spent in compliance with laws and regulations. Each Federal agency which provides Federal awards shall review the audits of the recipients to determine whether corrective actions are implemented with respect to audit findings.

Clinger-Cohen Act of 1996 (formerly known as the Information Technology Management Reform Act)

The Clinger-Cohen Act requires agencies to use a disciplined capital planning and investment control (CPIC) process to maximize the value of and assess and manage the risks of the information technology acquisitions. The Act requires that agencies "(1) establish goals for improving the efficiency and effectiveness of agency operations and, as appropriate, the delivery of services to the public through the effective use of information technology; (2) prepare an annual report...on the progress in achieving the goals; (3) ensure that performance measurements are prescribed for information technology used by, or to be acquired for, the executive agency and that the performance measurements measure how well the information technology supports programs of the executive agency; (4) where comparable processes and organizations in the public or private sectors exist, quantitatively benchmark agency process performance against such processes in terms of cost, speed, productivity, and quality of outputs and outcomes; (5) analyze the missions of the executive agency and, based on the analysis, revise the executive agency's mission-related processes and administrative processes as appropriate before making significant investments in information technology that is to be used in support of the performance of those missions; and (6) ensure that the information security policies, procedures, and practices of the executive agency are adequate."

A. Developing Internal Control. It is management's responsibility to develop and maintain effective internal control. As agencies develop and execute strategies for implementing or reengineering agency programs and operations, they should design management structures that help ensure accountability for results. As part of this process, agencies and individual Federal managers must take systematic and proactive measures to develop and implement appropriate, cost-effective internal control. The degree to which studies and analysis are performed will vary depending on the complexity and risk associated with a given program or operation. The expertise of the agency CFO can be valuable in developing appropriate control and the IG can be valuable in providing advice or consultation. Decisions made during this process should be documented and readily available for review.

IV. ASSESSING INTERNAL CONTROL

Agency managers should continuously monitor and improve the effectiveness of internal control associated with their programs. This continuous monitoring, and other periodic assessments, should provide the basis for the agency head's annual assessment of and report on internal control, as required by FMFIA.

Agency management should determine the appropriate level of documentation needed to support this assessment. Documentation should be appropriately detailed and organized and contain sufficient information to support management's assertion. Documentation should also include appropriate representations from officials and personnel responsible for monitoring, improving and assessing internal controls. Specific assessment and documentation requirements to support management's assurance statement on internal control over financial reporting are defined in Appendix A.

A. Sources of Information. The agency head's assessment of internal control can be performed using a

variety of information sources. Management has primary responsibility for assessing and monitoring controls, and should use other sources as a supplement to -- not a replacement for -- its own judgment. Sources of information include:

- Management knowledge gained from the daily operation of agency programs and systems.
- Management reviews conducted (i) expressly for the purpose of assessing internal control, or (ii) for other purposes with an assessment of internal control as a by-product of the review.
- IG and GAO reports, including audits, inspections, reviews, investigations, outcome of hotline complaints, or other products.
- Program evaluations.
- Audits of financial statements conducted pursuant to the CFO Act, as amended, including: information revealed in preparing the financial statements; the auditor's reports on the financial statements, internal control, and compliance with laws and regulations; and any other materials prepared relating to the statements.
- Reviews of financial systems which consider whether the requirements of FFMA and OMB Circular No. A-127, *Financial Management Systems*⁵ are being met.
- Annual evaluations and reports pursuant to FISMA and OMB Circular No. A-130, *Management of Federal Information Resources*⁶.
- Annual performance plans and reports pursuant to GPRA.
- PART assessments.
- Annual reviews and reports pursuant to IPIA.
- Single Audit reports for grant-making agencies.
- Reports and other information provided by the Congressional committees of jurisdiction.
- Other reviews or reports relating to agency operations, e.g. for the Department of Health and Human Services, quality control reviews of the Medicaid and Temporary Assistance for Needy Families programs.
- Results from tests of key controls performed as part of the assessment of internal control over financial reporting conducted in accordance with the requirements in Appendix A.

Use of a source of information should take into consideration whether the process included an evaluation of internal control. Agency management should avoid duplicating reviews which assess internal control, and should coordinate their efforts with other evaluations to the extent practicable.

If a Federal manager determines that there is insufficient information available upon which to base an assessment of internal control, then appropriate reviews should be conducted which will provide such a basis.

B. Identification of Deficiencies. Agency managers and employees should identify deficiencies in internal control from the sources of information described above and the results of their assessment process. Agency employees and managers shall report control deficiencies to the next supervisory level, which will allow the chain of command structure to determine the relative importance of each deficiency.

A control deficiency or combination of control deficiencies that in management's judgment represent significant deficiencies in the design or operation of internal control that could adversely affect the organization's ability to meet its internal control objectives is a reportable condition (internally tracked and monitored within the agency). A reportable condition that the agency head determines to be significant enough to be reported outside the agency shall be considered a material weakness⁷ and included in the annual FMFIA assurance statement and reported in the agency's annual PAR. As it relates to financial reporting, agencies should also consider qualitative as well as quantitative measures to determine material items. This designation requires a judgment by agency managers as to the relative risk and significance of reportable conditions. In identifying and assessing the relative importance of reportable conditions, consideration should be given to the views of the agency's IG. Definitions of reportable conditions and material weaknesses for management's assessment of internal control over financial reporting are provided in Appendix A Section II. *Scope*. Additionally, definitions and reporting requirements are summarized in Exhibit 1. The "significant deficiencies" identified under FISMA must be reported as material weaknesses in the annual FMFIA report.

Agency managers and staff should be encouraged to identify control deficiencies, as this reflects

positively on the agency's commitment to recognizing and addressing management problems. Failing to report a known reportable condition would reflect adversely on the agency and continue to place the agency's operations at risk. Agencies should carefully consider whether systemic weaknesses exist that adversely affect internal control across organizational or program lines.

C. Role of a Senior Management Council. Many agencies use a Senior Management Council to assess and monitor deficiencies in internal control. A Senior Management Council, which may include the Chief Financial Officer, the Senior Procurement Executive, the Chief Information Officer, and the managers of other functional offices, should be involved in identifying and ensuring correction of systemic weaknesses relating to their respective functions. Consideration should be given to involving the IG in a consulting capacity but not to conduct management's assessment of internal controls. Such councils generally recommend to the agency head which reportable conditions are deemed to be material weaknesses to the agency as a whole, and should therefore be included in the annual FMFIA assurance statement and reported in the agency's PAR. This council should be responsible for overseeing the timely implementation of corrective actions related to material weaknesses. Such a council may also be useful in determining when sufficient action has been taken to declare that a reportable condition or material weakness has been corrected. While the establishment of such a council is not a requirement of this document, a Senior Management Council or similar construct is encouraged.

V. CORRECTING INTERNAL CONTROL DEFICIENCIES

Agency managers are responsible for taking timely and effective action to correct deficiencies identified by the variety of sources discussed in Section IV, Assessing Internal Control. Correcting deficiencies is an integral part of management accountability and must be considered a priority by the agency.

The extent to which corrective actions are tracked by the agency should be commensurate with the severity of the deficiency. Corrective action plans should be developed for all material weaknesses, and progress against plans should be periodically assessed and reported to agency management. Management should track progress to ensure timely and effective results. For reportable conditions that are not included in the FMFIA report, corrective action plans should be developed and tracked internally at the appropriate level.

A summary of the corrective action plans for material weaknesses shall be included in the agency's PAR. The summary discussion shall include a description of the material weakness, status of corrective actions, and timeline for resolution.

Management shall maintain more detailed corrective action plans internally which shall be available for OMB review. Management's process for resolution and corrective action of identified material weaknesses in internal control must:

- Provide for appointment of an overall corrective action accountability official from senior agency management. The corrective action accountability official should report to the agency's Senior Management Council, if applicable.
- Require prompt resolution and corrective actions.
- Maintain accurate records of the status of the identified material weaknesses through the entire process of resolution and corrective action.
- Assure that the corrective action plans are consistent with laws, regulations, and Administration policy.
- Assure that performance appraisals of appropriate officials reflect effectiveness in resolving or implementing corrective action for identified material weaknesses⁸.

A determination that a reportable condition has been corrected should be made only when sufficient corrective actions have been taken and the desired results achieved. This determination should be in writing, and along with other appropriate documentation supporting the determination, should be available for review by appropriate officials. (See also Section IV.C. *Role of a Senior Management Council*.)

As managers consider IG and GAO audit reports in identifying and correcting internal control deficiencies, they must be mindful of the statutory requirements for audit follow-up included in the IG Act, as amended and OMB Circular A-50, *Audit Followup*. Management has a responsibility to complete action, in a timely manner, on audit recommendations on which agreement with the IG has been reached. Management must make a decision regarding IG audit recommendations within a six month period after issuance of the audit report and implement management's decision within one year to the extent practicable.

VI. REPORTING ON INTERNAL CONTROL

A. Annual Assurance Statements. The assurance statements and information related to Section 2, Section 4, and internal control over financial reporting should be provided in a single FMFIA report section of the annual PAR labeled "Management Assurances." The section should include the annual assurance statements, summary of material weaknesses and non-conformances, and summary of corrective action plans. Management's assurance statement relating to internal control over financial reporting and any related material weaknesses and corrective actions shall be separately identified.

B. Reporting Pursuant to Section 2. 31 U.S.C. 3512(d) (2) (commonly referred to as Section 2 of the FMFIA) requires that annually the head of each executive agency submit to the President and the Congress (i) a statement on whether there is reasonable assurance that the agency's controls are achieving their intended objectives; and (ii) a report on material weaknesses in the agency's controls.

- **Statement of Assurance.** The statement of assurance represents the agency head's informed judgment as to the overall adequacy and effectiveness of internal control within the agency. The statement must take one of the following forms:
 - Unqualified statement of assurance (no material weaknesses reported);
 - Qualified statement of assurance, considering the exceptions explicitly noted (one or more material weaknesses reported); or
 - Statement of no assurance (no processes in place or pervasive material weaknesses).

In deciding on the type of assurance to provide, the agency head should consider information from the sources described in Section III of this Circular, with input from senior program and administrative officials and the IG. The agency head must describe the analytical basis for the type of assurance being provided, and the extent to which agency activities were assessed. Management is precluded from concluding that the agency's internal control is effective (unqualified statement of assurance) if there are one or more material weaknesses. The statement of assurance must be signed by the agency head.

- **Statement of Assurance for Internal Control over Financial Reporting.** Management is required to provide a separate assurance over the effectiveness of the internal controls over financial reporting. This assurance is a subset of the overall Statement of Assurance and is based on the results of management's assessment conducted in accordance with the requirements in Appendix A. Refer to Appendix A Section V. *Management's Assurance Statement on Internal Control over Financial Reporting* for a further discussion.

C. Reporting Pursuant to Section 4. 31 U.S.C. 3512(d) (2) (B) (commonly referred to as Section 4 of the FMFIA) requires an annual statement on whether the agency's financial management systems conform to government-wide requirements. These financial systems requirements are mandated by the FFMA and OMB Circular No. A-127, *Financial Management Systems*, section 7. If the agency's systems do not substantially conform to financial systems requirements, the statement must list the nonconformances and discuss the agency's plans for bringing its systems into substantial compliance. Financial management systems include both financial and financially-related (or mixed) systems.

D. Government Corporations. For government corporations, Section 306 of the Chief Financial Officers Act established a reporting requirement related to the internal controls for corporations covered by the Government Corporation and Control Act. These corporations must submit an annual management

report to the Congress. This report must include, among other items, a statement on control systems by the head of the management of the corporation consistent with the requirements of the FMFIA. The corporation is required to provide the President, the Director of OMB, and the Comptroller General a copy of the management report when it is submitted to Congress.

Exhibit 1: Summary of A-123 reporting requirements

	Definition⁹	Reporting
Control Deficiency (FMFIA Section 2 and internal control over financial reporting)	Control deficiencies exist when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A design deficiency exists when a control necessary to meet the control objective is missing or an existing control is not properly designed, so that even if the control operates as designed the control objective is not always met. An operation deficiency exists when a properly designed control does not operate as designed or when the person performing the control is not qualified or properly skilled to perform the control effectively.	Internal to the organization and not reported externally. Progress against corrective action plans should be periodically assessed and reported to agency management.
Reportable Condition (FMFIA Section 2 and internal control over financial reporting)	FMFIA overall – A control deficiency, or combination of control deficiencies, that in management’s judgment, should be communicated because they represent significant weaknesses in the design or operation of	Internal to the organization and not reported externally. Progress against corrective action plans should be periodically assessed and reported to agency management.

	<p>internal control that could adversely affect the organization's ability to meet its internal control objectives.</p> <p>Financial reporting – A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote¹⁰ likelihood that a misstatement of the entity's financial statements, or other significant financial reports, that is more than inconsequential will not be prevented or detected.</p>	
<p>Material Weakness (FMFIA Section 2 and internal control over financial reporting)</p>	<p>FMFIA overall – Reportable conditions in which the agency head determines to be significant enough to report outside of the agency.</p> <p>Financial reporting – Reportable condition, or combination of reportable conditions, that results in more than a remote¹¹ likelihood that a material misstatement of the financial statements, or other significant financial reports, will not be</p>	<p>Material weaknesses and a summary of corrective actions shall be reported to OMB and Congress through the PAR (Management Report for Government Corporations). Progress against corrective action plans should be periodically assessed and reported to agency management.</p>

	prevented or detected.	
Non-conformance (FMFIA Section 4)	Instances in which financial management systems do not substantially conform to financial systems requirements. Financial management systems include both financial and financially-related (or mixed) systems.	Non-conformances and a summary of corrective actions to bring systems into conformance shall be reported to OMB and Congress through the PAR (Management Report for Government Corporations). Progress against corrective action plans should be periodically assessed and reported to agency management.

APPENDIX A: INTERNAL CONTROL OVER FINANCIAL REPORTING

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- II. Scope
- III. Assessing Internal Control over Financial Reporting
- IV. Documentation
- V. Management's Assurance Statement on Internal Control over Financial Reporting
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I. INTRODUCTION

This Appendix provides a methodology for agency management to assess, document, and report on the internal controls over financial reporting. This document also encourages an integrated approach to assessing the internal controls over financial reporting considering the current legislative and regulatory environment in which Federal entities operate.

Effective internal control over financial reporting provides reasonable assurance that misstatements, losses, or noncompliance with applicable laws and regulations, material in relation to financial reports, would be prevented or detected.¹²

The Sarbanes-Oxley Act of 2002 required that management of publicly-traded companies strengthen their processes for assessing and reporting on the internal controls over financial reporting. The passage of the Sarbanes-Oxley Act served as an impetus for the Federal government to reevaluate its current policies relating to internal control over financial reporting and management's related responsibilities. While the Sarbanes-Oxley Act created a new requirement for managers of publicly-traded companies to report on the internal controls over financial reporting, Federal managers have been subject to similar internal control reporting requirements for many years.

Federal agencies are subject to numerous legislative and regulatory requirements that promote and support effective internal control. The Federal Managers' Financial Integrity Act (FMFIA) of 1982 provides the statutory basis for management's responsibility for and assessment of internal control. In addition, the Chief Financial Officers Act (CFO Act) of 1990 requires agency CFOs to, "develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls, which ... complies with applicable ... internal control standards..." The Federal Financial Management Improvement Act (FFMIA) of 1996 and OMB Circular No. A-127, *Financial Management Systems* also instruct agencies to maintain an integrated financial management system that complies with Federal system requirements, FASAB Standards, and the USSGL at the transaction level. The Inspector General Act (IG Act) of 1978, as amended requires that IGs submit semiannual reports to the Congress on significant abuses and deficiencies identified during these reviews and the recommended actions to correct those deficiencies. The GAO *Government Auditing Standards* (Yellow Book) and OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements, as amended* require auditors to test and report on internal control as part of a Federal agency financial statement audit, including a description of reportable conditions and material weaknesses in internal control over financial reporting.

Recent government-wide initiatives have also contributed to improvements in financial management and placed greater emphasis on implementing and maintaining effective internal control over financial reporting. These initiatives include aggressive OMB quarterly tracking of corrective actions for material

