



PUBLIC SECTOR

# **OMB Circular No. A-123 -- Revised *Management's Responsibility for Internal Controls***

ADVISORY

# Contents

- **Background**
- **Federal Managers' Financial Integrity Act (FMFIA) of 1982**
- **Office of Management and Budget (OMB) Circular No. A-123**
  - Significant Revisions
  - Management Responsibilities
  - Government Accountability Office's (GAO's) Green Book
  - Integrate Compliance into the Internal Control Framework
  - Annual Assurance Statement
  - Deficiency Definitions
  - Appendix A, Internal Control Over Financial Reporting (ICOFR)
  - Sample Assurance Statement on ICOFR
- **Additional Resources**

# Background

## ▪ **FMFIA of 1982**

- A statutory requirement.
- Amended the Accounting and Auditing Act of 1950
- Requires evaluations and reports on the adequacy of the systems of internal accounting and administrative control.

## ▪ **OMB Circular No. A-123**

- Provided guidance to implement the FMFIA of 1982.
- Guidance has evolved:
  - Circular No. A-123, Internal Control Systems, revised, dated August 4, 1986, replaced;
  - Circular No. A-123, Management Accountability and Control, revised, dated June 21, 1995, effective through 09/30/05; and
  - Circular No. A-123, Management's Responsibility for Internal Controls, revised, dated December 21, 2004, effective on 10/01/05.

## FMFIA of 1982

- **Internal accounting and administrative controls of each executive agency shall be established in accordance with standards prescribed by the Comptroller General, and shall provide reasonable assurances that:**
  - Obligations and costs are in compliance with applicable law;
  - Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
  - 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.
- **Annually, an agency head must evaluate and report on the control and financial systems that protect the integrity of federal programs.**

# OMB Circular No. A-123

- **Defines management's responsibility for internal controls for federal agencies and government corporations.**
- **Appendix A revision was influenced by the Sarbanes-Oxley Act of 2002 and was based on recommendations by a joint committee:**
  - Required for the 24 Chief Financial Officer (CFO) Act of 1990 agencies;
  - Strengthen the requirements for conducting management's assessments of ICOFR; and
  - Emphasize the need for agencies to integrate and coordinate their internal control assessments with other related assessment activities.
- **Effective October 1, 2005, for federal fiscal year 2006.**

# Significant Revisions

- **Mandates FMFIA annual assurance statement to be included within an agency's Performance Accountability Report (PAR).**
- **Updates internal control standards and changes certain terminology.**
- **Integrates related statutes into an agency's internal control framework.**
- **Establishes a Senior Management Council and Senior Assessment Team.**
- **Defines the type of ICOFR deficiencies.**
- **Requires management to document its assessment process and test of controls.**
- **Appendix A describes a high-level process to assess, document, and report.**

***Does not require an audit opinion for internal controls.***

# Management Responsibilities

- **Establish and maintain internal controls to achieve the following objectives:**
  - Effective and efficient operations;
  - Reliable financial reporting; and
  - Compliance with applicable laws and regulations.
- **Safeguard assets.**
- **Develop and implement appropriate, cost-effective internal controls for results-oriented management.**
- **Assess the adequacy of internal control in federal programs and operations.**
- **Separately assess and document ICOFR consistent with Appendix A.**
- **Identify needed improvements and take corresponding corrective actions.**
- **Report annually on internal control through management assurance statements.**

# GAO's Green Book

## ▪Control Environment

- The control environment sets the tone of an organization, influencing the control consciousness of its people.

## ▪Risk Assessment

- Every entity faces a variety of risks from external and internal sources that must be assessed at both the entity and the activity level.

## ▪Control Activities

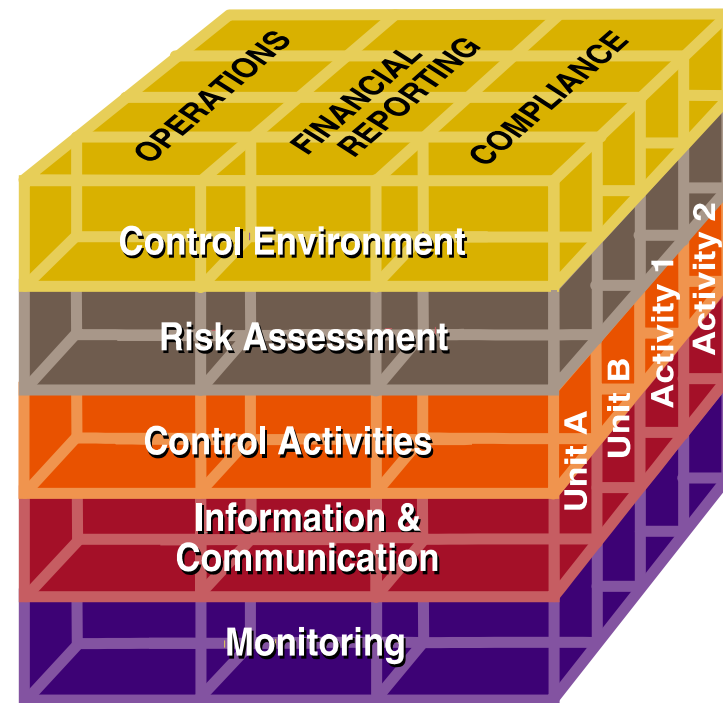
- These policies and procedures help ensure management directives are carried out.

## ▪Information and Communication

- Pertinent information must be identified, captured, and communicated in a form and time frame that supports all other control components.

## ▪Monitoring

- Internal control systems need to be monitored - a process that assesses the quality of the system's performance over time.



# Integrate Compliance into the Internal Control Framework

- **Federal agencies are subject to numerous legislative and regulatory requirements that should be considered as part of an agency's internal control framework:**
  - FMFIA of 1982;
  - Government Performance and Results Act (GPRA) of 1993;
  - CFO Act of 1990;
  - Inspector General Act of 1978;
  - Federal Financial Management Improvement Act (FFMIA) of 1996;
  - Federal Information Security Management Act (FISMA) of 2002;
  - Improper Payments Information Act (IPIA) of 2002;
  - Single Audit Act of 1984, as amended in 1996; and
  - Information Technology Management Reform Act (ITMRA) of 1996, i.e. The Clinger-Cohen Act of 1996.

# Annual Assurance Statement

- **FMFIA Annual Assurance Statement previously included:**

- Section 2, Internal Controls Achieved Objectives; and
- Section 4, Conformance with System Requirements.

- **OMB Circular No. A-123 consolidates these statements of assurance:**

- Overall adequacy and effectiveness of internal controls, both financial, operational, and compliance;
- Each annual statement prepared pursuant to Section 4 shall include a separate report on whether the agency's accounting system conforms to the principles, standards, and related requirements prescribed by the Comptroller General; and
- Under the revised A-123, includes a Statement of Assurance on the ICOFR.

# Deficiency Definitions

<u>Type of Deficiency</u>	<u>Definition</u>	<u>Reporting</u>
<b>Control Deficiency</b> <ul style="list-style-type: none"> <li>▪ FMFIA Section 2</li> <li>▪ ICOFR</li> </ul>	Design or operation of a control does not prevent or detect misstatements on a timely basis	Internal
<b>Reportable Condition</b> <ul style="list-style-type: none"> <li>▪ FMFIA Section 2</li> <li>▪ ICOFR</li> </ul>	<p><b>FMFIA</b> – Management judgment as a significant weaknesses that could adversely affect ability to meet internal control objectives</p> <p><b>ICOFR</b> – More than a <u>remote likelihood</u> that a misstatement is <u>more than inconsequential</u> will not be prevented or detected</p>	Internal
<b>Material Weakness</b> <ul style="list-style-type: none"> <li>▪ FMFIA Section 2</li> <li>▪ ICOFR</li> </ul>	<p><b>FMFIA</b> – Reportable Conditions in which the agency head determines to be significant enough to report outside the agency</p> <p><b>ICOFR</b> – Reportable Condition(s) results in more than a <u>remote likelihood</u> that a material misstatement will not be prevented or detected</p>	External
<b>Nonconformance</b> <ul style="list-style-type: none"> <li>▪ FMFIA Section 4</li> </ul>	Instances in which financial management system (including mixed systems) do not substantially conform to financial system requirements	External

# Appendix A, ICOFR

- **Applies to all three internal control objectives:**
  - Operational;
  - Financial (including the assessment of ICOFR); and
  - Compliance.
- **OMB Circular No. A-123, Appendix A provides a methodology for agency management to assess, document, and report on their ICOFR. The five key activities are:**
  - **Scope** defines the boundaries of the assessment;
  - **Assess** sets accountability and evaluates controls at the entity, process, transaction, or application levels;
  - **Document** defines the extent of documentation;
  - **Report** defines the the statement of assurance; and
  - **Correct** defines the expectations for correcting material weaknesses.

# Appendix A, ICOFR -- Scope

## ▪ Objectives of ICOFR

- Should provide reasonable assurance to enable management to make the following assertions:
  - Existence and occurrence; Completeness; Rights and obligations; Valuation; Presentation and disclosure; Compliance;
  - Assets are safeguarded against fraud and abuse; and
  - Documentation for internal control, all transactions, and other significant events is readily available for examination.

## ▪ Definition of Financial Reporting

- An agency needs to determine the scope of financial reports that are significant; i.e. which reports are included in their assessment of ICOFR.

# Appendix A, ICOFR -- Scope, Continued

## ▪ **Planning Materiality**

- Risk of error or misstatement that could occur in a financial report that would impact management's or a users' decision or conclusion;
- Planning materiality should be set at a lower threshold than the reporting materiality to ensure detection of items required to be reported;
- Materiality should be determined for each financial report included in the scope of the assessment;
- Materiality will differ from report to report and will determine the extent of testing; and
- Materiality should consider qualitative as well as quantitative measures.

## ▪ **Definition of Deficiencies**

- Control deficiency: Design and operation of a control that does not prevent or detect a deficiency.
- Reportable condition: More than a remote likelihood a more than inconsequential financial statement misstatement could occur.
- Material weakness: More than a remote likelihood that a material misstatement will not be prevented or detected.

# Appendix A, ICOFR -- Assess

- **Establish a Senior Assessment Team to ensure:**
  - Clear communication;
  - The assessment is thorough, effective, and completed in a timely manner;
  - There is adequate funding and resources are available;
  - The identification of staff or contractors to perform the assessment; and
  - The determination of the scope, assessment design, and methodology of the assessment.
- **Evaluate Internal Controls at the Entity Level**
  - Use the GAO's Green Book as guidance, complete an Entity Level Control questionnaire.

# Appendix A, ICOfR -- Assess, Continued

- **Evaluate Internal Controls at the Process, Transaction, or Application Levels**
  - Determine significant accounts or group of accounts;
  - Identify and evaluate the major classes of transactions;
  - Understand the financial reporting process;
  - Gain an understanding of control design to achieve management's assertions;
  - Controls not adequately designed; and
  - Test controls and assess compliance to support management's assertions.

# Appendix A, ICOFR -- Assess, Continued

- **Overall Assessment of the Design and Operation of ICOFR**
  - Concluding on the effectiveness of the ICOFR.
- **Reliance on Other Work to Accomplish Assessment**
  - Coordinate to avoid duplication of effort (FMFIA, FISMA, etc.):
    - Should be performed by management, or at management's direction;
    - May consult with Inspector General (IG) to plan and coordinate; and
    - IG may advise, but shall not conduct management's ICOFR assessment.
  - Weakness related to service organizations need to be considered.

# Appendix A, ICOFR -- Document

## ▪ Documenting ICOFR should include:

- Establishing Senior Assessment Team, its authority, and members;
- Contracting actions, if necessary;
- Internal project management communications and **key** decisions;
- Assessment methodology and guide;
- Assessing of internal controls at the entity level and process, transaction, or application levels;
- Testing of controls and related results; and
- Identifying deficiencies and suggestions for improvement.

## ▪ Artifacts may include:

- Organizational charts, flow charts, questionnaires, decision tables, and memorandums; and
- Documentation prepared by internal and external auditors.

# Appendix A, ICOFR -- Report

## ■ Management's Assurance Statement on ICOFR

- An assessment of the effectiveness of ICOFR as of June 30<sup>th</sup>;
- Includes a statement of management's responsibility for establishing and maintaining an effective system of ICOFR;
- Identifies OMB Circular No. A-123 as the framework for the assessment;
- If a material weakness is discovered by June 30<sup>th</sup> and corrected by September 30<sup>th</sup>, then prepare a statement identifying the material weakness, the corrective action taken, and that it has been resolved by September 30<sup>th</sup>; and
- If a material weakness is discovered after June 30<sup>th</sup> and prior to September 30<sup>th</sup>, the statement identifying the material weaknesses should be updated to include the subsequently identified material weakness.

# Appendix A, ICOFR -- Report, Continued

## ▪ Assurance Statement concludes on effectiveness:

- Unqualified, i.e. no material weaknesses reported;
- Qualified, i.e. one or more material weaknesses, and precluded from concluding that an effective internal control environment exists, unless corrective action is implemented and verified by September 30<sup>th</sup>; and
- Statement of no assurance, i.e. no process in place, pervasive material weaknesses, and internal control is not effective.

## ▪ Audit Opinions on Internal Control

- Not required by OMB Circular No. A-123, but may be imposed by OMB for failure to implement corrective action in a timely manner; and
- Agencies may elect at their discretion to receive an audit opinion and may adjust the “as of” reporting date of June 30<sup>th</sup> to coincide with the “as of” reporting date of the audit opinion on internal controls.

# Sample Assurance Statement on ICOFR

**Fiscal Year 2xxx**

## **Annual Assurance Statement on Internal Control over Financial Reporting**

The [Agency's] management is responsible for establishing and maintaining effective internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations. The [Agency] conducted its assessment of the effectiveness of the [Agency's] internal control over financial reporting in accordance with OMB Circular No. A-123, Management's Responsibility for Internal Control. Based on the results of this evaluation, the [Agency] can provide reasonable assurance that the internal control over financial reporting as of June 30, 2xxx was operating effectively and no material weaknesses were found in the design or operation of the internal controls over financial reporting.

---

Head of the Agency

# Additional Resources

- **OMB Circular No. A-123 Implementation Guide**

- A supplement to OMB Circular No. A-123 to assist federal agency managers in implementing the requirements of OMB Circular No. A-123.

- **GAO Internal Control Management and Evaluation Tool**

- A tool to assist federal agency managers in assessing internal controls, i.e. GAO 01-1008G – August 2001.

- **KPMG LLP Assessing Internal Control Over Financial Reporting: A Guide for Implementing Appendix A of OMB Circular A-123.**

- A desk guide to assist federal agency managers in performing their OMB A-123 assessment.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

**William G. Ashby, CPA, CGFM**  
**KPMG LLP**  
**916.554.1658**  
**washby@kpmg.com**  
**www.kpmg.com**

KPMG International, as a Swiss cooperative, is a network of independent member firms. KPMG International provides no audit or other services to clients. Such services are provided solely by member firms in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners or joint ventures. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any member firm in any manner whatsoever.

