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DEPARTMENTAL DIRECTIVE

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Approved by: _____/s/_____
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Federal Managers' Financial Integrity Act
Management/Reporting on Internal Controls

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Supersedes OCFO:1-101, Federal Managers' Financial Integrity Act Management/Reporting on Internal Controls, dated 09/29/2003.

I.   Purpose

This directive establishes the overall policies and procedures to be followed by the U.S. Department of Education's (ED) Principal Offices (POs) in complying with the requirements of the *Federal Managers' Financial Integrity Act (FMFIA) of 1982 as codified in 31 U.S.C. 3512* and the Office of Management and Budget (OMB) Circular A-123 (Revised), *Management's Responsibility for Internal Control* for establishing, assessing, improving, and reporting on internal controls in their administrative and program activities. Additional policies and procedures for financial system internal controls are contained in OCFO:1-103, *Financial Management*.

The Financial Improvement and Post Audit Operations (FIPAO), Internal Control Evaluation Group (ICEG), of the Office of the Chief Financial Officer (OCFO), provides procedures, instructions, training, and technical assistance, as appropriate, for the conduct of activities required by this directive.

II.   Authorization

The FMFIA requires internal control systems be established in accordance with standards prescribed by the Comptroller General and guidelines prescribed by the Office of Management & Budget (OMB). It also requires each executive agency to conduct continuous evaluations and report annually to the President and the Congress on the adequacy of its internal control systems. OMB Circular A-123, *Management's Responsibility for Internal Control,* interprets Section 2 of FMFIA. OMB Circular A-127, *Financial Management Systems,* interprets Section 4 of FMFIA.

Circular A-123 defines management's responsibility for internal control in Federal agencies. The 2004 revision to the Circular was initiated in light of the new internal control requirements for publicly traded companies contained in the Sarbanes-Oxley Act of 2002. The Circular, which provides guidance on the implementation of FMFIA, and the statute itself are at the center of the existing Federal requirements to improve internal financial controls.

III.   Policy

It is the policy of ED to safeguard the resources entrusted to it against fraud, waste, mismanagement, and misappropriation. To that end, the Secretary and the Principal Officers are responsible for establishing and maintaining internal control to achieve the following objectives to ensure: effective and efficient operations, reliable financial reporting, compliance with applicable laws and regulations and that the mission of the agency is achieved. 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 OMB Circular A-123, Appendix A. Annually, management must provide assurances on internal control in its Performance and

Accountability Report (PAR), including a separate assurance on internal control over financial reporting, along with a report on identified material weaknesses and corrective actions.

Individual program and administrative managers must take systematic and proactive measures to: (1) develop and implement appropriate, cost-effective internal control for results-oriented management; (2) assess the adequacy of internal control in Federal programs and operations; (3) separately assess and document internal control over financial reporting consistent with the process defined in OMB Circular A-123, Appendix A; (4) identify needed improvements; (5) take corresponding corrective action; and (6) report annually on internal control through management assurance statements.

IV.   Applicability

The provisions of this directive apply to all of ED's programs and administrative activities in all of its Principal Offices (POs), including Regional Offices, and to all managers at all organizational levels.

V.   Definitions

For the purpose of this directive, the following terms are defined:

A. Internal Control Contact (ICC). The official designated by the Principal Officer to coordinate, manage, and report on PO internal control activities on behalf of the Principal Officer and to act as the PO's principal point of contact with ICEG.

B. Internal Control Documentation. Includes the policies and procedures, organization charts, manuals, memoranda, flow charts, and related written materials necessary to describe organizational structure, operating procedures, and administrative practices; and to communicate responsibilities and authorities for accomplishing programs and activities. Such documentation should be present to the extent required by management to effectively control their operations. The documentation may be electronic, hard copy format, or both, and should be readily available for review, and reviewed or updated annually. Documentation should also include appropriate representations from officials and personnel responsible for monitoring, improving and assessing internal controls.

C. Objectives of Internal Control. Internal control is an integral component of an organization's management that provides reasonable assurance the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations and the agency's mission can be achieved. The objectives of internal control apply to all program and administrative activities. Internal control includes processes for planning, organizing, directing, controlling, and reporting on agency operations. The safeguarding of assets is a subset of all these objectives. Internal control should be designed to provide reasonable assurance regarding the prevention or prompt detection of unauthorized use or disposition of assets.

D. <u>Internal Control Standards</u>. The standards are identified in OMB Circular A-123 (Revised). These standards include Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. Complying with these standards should provide reasonable assurance ED meets the objectives of internal control.

E. <u>Internal Control System</u>. A system of internal controls comprising the organization structure, operating procedures, and administrative practices adopted by all levels of management to provide reasonable assurance that programs and administrative activities are efficiently carried out in accordance with the objectives of the FMFIA and OMB Circular A-123.

F. <u>Material Weaknesses</u>. Specific instances of noncompliance with the FMFIA of sufficient importance to be reported to the President and the Congress. Such weaknesses would significantly impair the fulfillment of ED's or a PO's mission; deprive the public of needed services; violate statutory or regulatory requirements; significantly weaken safeguards against waste, loss, unauthorized use, or misappropriation of funds, property, or other assets; or result in a conflict of interest. OMB Circular A-123 Appendix A, Section II. Scope C.

G. <u>Principal Officer</u>. An Assistant Secretary or equivalent head of an ED organization that reports directly to the Secretary. A Principal Officer is the head of a PO.

H. <u>Principal Office</u>. A major organizational subdivision of ED that has one or more separated systems of internal control.

I. <u>Reasonable Assurance</u>. No matter how well designed and operated, internal controls cannot provide absolute assurance all control objectives will be met. Therefore, internal controls provide reasonable, not absolute, assurance of meeting the internal control objectives.

J. <u>Reportable Condition</u>. 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.

K. <u>Resources</u>. Resources are tangible or intangible assets susceptible to loss. Examples of tangible assets include personnel, information, capital, and property and equipment. Examples of loss of intangible assets include failure to accomplish a mission, public controversy, loss of public confidence, endangerment of health and safety, and decrease in productivity.

VI. Responsibilities

All managers within ED are responsible for ensuring the development, maintenance, documentation, evaluation, and improvement of internal control for the programs and administrative functions for which they are responsible. ED managers are also responsible to ensure their programs and administrative activities are in compliance with

the requirements of the FMFIA, OMB Circular A-123, and ED-wide policies. Specific responsibilities are listed below.

A. <u>The Secretary</u>. The Secretary has the overall responsibility for:

   1. Ensuring that ED's systems of internal control comply with the requirements of FMFIA and OMB Circular A-123; and

   2. Providing an annual Statement of Assurance to the President and the Congress on the status of ED's overall systems of internal control that satisfies the reporting requirements of FMFIA.

B. <u>The Chief Financial Officer (CFO)</u>. The Secretary has designated the CFO as the Senior Internal Control Official for ED. As the Senior Internal Control Official, the CFO is responsible for:

   1. Coordinating the overall ED-wide effort to comply with the FMFIA and OMB Circular A-123;

   2. Submitting an annual report to the Secretary (based on the Principal Officers' Letters of Assurance) on the status of ED's compliance activities and systems of internal control; and

   3. Providing policies, procedures, and guidance to the Principal Officers for accomplishing required internal control activities.

C. The <u>Director, Financial Improvement and Post Audit Operations (FIPAO).</u> The CFO has designated the Director, FIPAO as the Director of Internal Control responsible for:

   1. Developing and issuing policies, procedures, and reporting requirements necessary to establish, assess, improve, and report on internal control systems;

   2. Arranging for or providing training and technical assistance for POs' internal control activities; and

   3. Developing and maintaining follow-up systems to monitor the implementation of corrective actions resulting from the internal control evaluation process.

D. <u>The Principal Officers</u> and their managers of programs and activities are responsible for establishing and maintaining cost-effective systems of internal control. This includes determining the system is established in accordance with the standards prescribed by OMB Circular A-123 and provides reasonable assurance the goals of the office are accomplished and the objectives of internal control as defined in this directive are met. Specifically, the Principal Officers are responsible for:

   1. Determining the system is functioning as prescribed and modifying the system, as appropriate;

2. Ensuring the type, number, and quality of management controls are sufficient to provide reasonable assurance of disclosing any existing weaknesses;

3. Taking prompt action to correct identified weaknesses;

4. Ensuring their systems of internal control and evaluations of those systems are properly documented;

5. Providing adequate resources for conducting required internal control activities and ensuring compliance by specifying employee accountability through program objectives, goals, and performance standards;

6. Ensuring effective quality assurance procedures are established and carried out;

7. Evaluating any identified internal control weaknesses to determine if they are reportable conditions (as defined by this Directive);

8. Submitting a <u>Statement of Assurance</u> to the Secretary at the close of each fiscal year on the status of their respective systems of internal control that reports any weaknesses deemed to be reportable; and

9. Designating an ICC who will be the principal point of contact with ICEG and who will coordinate, manage, and report on internal control activities on behalf of the Principal Officer.

E. <u>The Inspector General (IG)</u>. The IG issues reports resulting from program audits, evaluations, inspections, and investigations that provide insight into the effectiveness of ED's internal controls. The IG is responsible for:

1. Performing the same functions as other Principal Officers with respect to the operations of the Office of Inspector General (OIG);

2. Informing the Secretary of issues that, in the IG's judgment, warrant consideration as a material weakness from an ED-wide perspective; and

3. Ensuring evaluations of internal controls are included within the scope of audits and reflected in resultant reports or are otherwise communicated to Principal Officers, as appropriate.

VII. Major Steps In The Internal Control Process

ED's internal control process is consistent with the OMB-recommended approach for evaluating, improving, and reporting on internal controls. The process includes: (A) establishing internal controls; (B) assessing and improving internal controls; (C) taking corrective actions as appropriate; and (D) preparing reports on the results and status of activities. The following is an explanation of the requirements for those activities:

A. Establishing Internal Controls

Internal controls are the organizational policies and procedures used by agencies to reasonably ensure: (1) programs achieve their intended results; (2) resources are used consistent with agency mission; (3) programs and resources are protected from waste, fraud, and mismanagement; (4) laws and regulations are followed; and (5) reliable and timely information is obtained, maintained, reported, and used for decision making.

Internal controls include the plan of organization, methods, and procedures adopted by management to ensure its goals are met. Internal controls also include processes for planning, organizing, directing, and controlling program operations. Subsets of internal controls are the controls used to assure that there is prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets.

Developing Internal Controls. All ED managers must take systematic and proactive measures to develop and implement appropriate and cost-effective controls that help ensure accountability for results. Although internal controls guarantee neither the success of programs, nor the absence of waste, fraud, and mismanagement, they are a means of managing the risk associated with programs and operations. To help ensure controls are appropriate and cost effective, managers should consider the extent and cost of controls relative to the importance and risk associated with a given program.

Internal Control Standards. ED managers shall incorporate basic controls in the strategies, plans, guidance, and procedures that govern their programs and operations. Controls shall be consistent with the following standards, which are drawn in large part from the "Standards for Internal Control in the Federal Government," issued by the Government Accountability Office (GAO).

1. *Control Environment*. The control environment is an organizational structure and culture created by management and employees to sustain organizational support for effective internal control. Management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management.

2. *Risk Assessment*. Risk assessment by management should identify internal and external risks that may prevent the organization from meeting its objectives.

3. *Control Activities*. Control activities include policies, procedures and mechanisms in place to help ensure agency objectives are met. Several examples include: proper segregation of duties; physical controls over assets; proper authorization; and appropriate documentation and access to that documentation. Internal control activities help ensure management's directives are carried out. The control activities should be effective and efficient in accomplishing ED's control objectives.

4. *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 an agency communicate with outside organizations as well, whether providing information or receiving it. Information should be recorded and communicated to management and others within ED who need it and in a form and within a timeframe that enables them to carry out their internal control and other responsibilities.

5. *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. Deficiencies found in internal control should be reported to the appropriate personnel and management responsible for that area. A systematic process should be in place for addressing deficiencies. Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved.

The attached Internal Control Self-Assessment Checklist for POs provides a list of guiding factors that are examples of controls based on the GAO standards. The list should be used by POs to establish and assess internal controls.

B. Assessing and Improving Internal Controls

ED managers should continuously monitor and improve the effectiveness of internal controls associated with their programs. This continuous monitoring, and other periodic evaluations, provides the basis for the Secretary's annual assessment of and report on internal controls, as required by the FMFIA.

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

1. Management knowledge gained from the daily operation of agency programs and systems;

2. Management reviews and cost recovery audits conducted (i) expressly for the purpose of assessing controls, or (ii) for other purposes with an assessment of controls as a by-product of the review;

3. IG and GAO reports, including audits, inspections, reviews, investigations, outcome of hotline complaints, or other products;

4. Program evaluations;

5. Audits of financial statements conducted pursuant to the Chief Financial Officers Act, as amended, including: information revealed in preparing the financial statements; the auditor's reports on the financial statements, internal controls, and compliance with laws and regulations; and any other materials prepared relating to the statements;

6. Reviews of computer systems and applications;

7. Annual performance plans and reports pursuant to the Government Performance and Results Act;

8. Reports and other information provided by the Congressional committees of jurisdiction; and

9. Other reviews or reports relating to ED's operations.

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

Identification of Deficiencies. ED managers and employees should identify deficiencies in internal controls from the sources of information described above. A deficiency should be reported if it is or should be of interest to the next level of management. ED employees and managers generally report deficiencies to the next supervisory level, which allows the chain of command structure to determine the relative importance of each deficiency.

A deficiency the Secretary determines to be significant enough to be reported outside the agency (i.e., included in the annual FMFIA report to the President and the Congress) shall be considered a "material weakness." This designation requires a judgment by the Secretary as to the relative risk and significance of the deficiencies. Consideration should be given to the views of the IG. Managers should carefully consider whether systemic problems exist that adversely affect internal controls across organizational or program lines.

C. Taking Corrective Actions

ED managers are responsible for taking timely and effective action to correct identified control deficiencies. Correcting deficiencies is an integral part of management accountability and is a priority of ED.

Corrective action plans should be developed for all reportable conditions. Progress against plans will be tracked in the Audit Accountability and Resolution Tracking System (AARTS) and will be periodically assessed and reported to ED management.

A determination that a deficiency is no longer reportable or has been corrected should be made only when sufficiently planned corrective actions have been taken and the desired results achieved. This determination should be in writing and, along with other appropriate documentation, should be available for review by appropriate officials. The documentation should include a summary of actions taken to mitigate the reportable condition along with the status of any planned but not completed corrective actions and an affirmative statement the desired results have been achieved. Management must make a decision regarding IG audit recommendations

within six-months after issuance of the audit report and implement management's decision within one year to the extent practicable.

D. Preparing Reports

Required reporting on internal controls can be broken down into three subsections as follows:

1. 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 Performance and Accountability Report 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.

2. Reporting Pursuant to Section 2 (commonly referred to as Section 2 of the FMFIA). Requires that annually the head of each executive agency submit to the President and Congress; (a) a statement on whether there is reasonable assurance the agency's controls are achieving their intended objectives; and (b) a report on material weaknesses in the agency's controls.

3. Reporting Pursuant to Section 4 (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. The requirements for financial management systems are mandated by the FMFIA 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 nonconformance(s) and discuss the agency's plans for bringing its systems into substantial compliance. Financial management systems include both financial and related systems.

Principal Officers' Statements of Assurance to the Secretary, submitted in response to specific annual instructions, provide the primary basis for the Secretary's annual FMFIA Statement of Assurance.

Attachment - Internal Control Self-Assessment Checklist for POs
List of Guiding Standards

Control Environment

- PO management provides leadership to ensure integrity and ethical values are maintained and demonstrated by management and staff.

- All personnel achieve and maintain a level of competence that enables them to accomplish assigned duties and understand the importance of developing, implementing, and maintaining effective internal controls.

- Management's philosophy and operating style defines appropriate levels of risk and demonstrates the application of performance-based management in achieving the goals of the PO.

- The PO's organizational structure provides an effective framework for planning, directing, and controlling operations to achieve objectives.

- The Principal Officer appropriately assigns and delegates authority and responsibility for operating activities, reporting relationships, and authorization protocols.

- Human resource policies and practices include appropriate practices for hiring, orienting, training, evaluating, counseling, promoting, compensating, and disciplining personnel.

- Where appropriate, ED maintains a close relationship with the Congress and central oversight agencies such as the OMB.

Risk Assessment

- The PO establishes clear, consistent goals and objectives at the entity level.

- The PO establishes clear, consistent goals and objectives at the activity level.

- Management comprehensively identifies risks, utilizing such methods as qualitative and quantitative ranking of activities, management conferences, forecasting and strategic planning, and consideration of findings from audits and other assessments.

- Risks are analyzed for their potential effect by estimating the risk's significance, assessing the likelihood of occurrence, deciding how to manage risk, and implementing actions to mitigate risk.

- Mechanisms are provided to identify and deal with any special risks prompted by changes such as governmental, economic, industry, regulatory, and operating factors that can affect the achievement of entity-wide or activity-level goals and objectives.

Control Activities

- Control activities are an integral part of a PO's planning, implementing, reviewing and accountability for stewardship of government resources and achieving effective results.

- In assessing the appropriateness of the PO's internal control activities, management considers a wide range of diverse activities, such as approvals, authorizations, verifications, reconciliations, performance reviews, security activities, and the production of records and documentation.

- The PO establishes a security management program that includes general control over all data center operations.

- Access security controls are established to protect the systems and network from inappropriate access and unauthorized use.

- Application system development and maintenance controls are established to provide a structure for safely developing new systems and modifying existing systems.

- System software controls are established to provide control over the acquisition, implementation, and maintenance of all system software including the operating system, data-based management systems, telecommunications, security software, and utility programs.

- The PO establishes and implements written policies to ensure proper segregation of duties.

- The PO establishes procedures to ensure proper and effective service continuity for its computerized operations.

- The PO establishes controls designed to help ensure authorization of all transactions during the application process.

- The PO establishes controls designed to help ensure completeness and validity of all transactions during the application process.

- The PO establishes controls designed to help ensure accuracy and validity of all transactions during the application process.

- The PO establishes procedures to help ensure the integrity of processing and data files.

- The PO establishes procedures to ensure proper attendance and leave consistent with ED-wide policies.

- The PO establishes procedures to ensure time worked and absences from work are properly identified and only reliable data are entered into the system.

- In order to realize the potential of its employees, the PO acts in accordance with the Department's Performance Appraisal System (EDPAS).

- The PO establishes policies and procedures for processing Freedom of Information Act (FOIA) requests.

- The PO establishes policies and procedures that ensure employee development needs are identified and specific training activities are designed to meet those needs.

- The exit clearance of separating employees is conducted expeditiously and in accordance with ED policies and procedures.

- To ensure proper and efficient travel, the PO acts in accordance with the Federal Travel Regulations (FTR) and the current ED requirements for travel.

- The PO management and staff must comply with Federal procurement policies and procedures.

- The PO follows established guidance and procedures with respect to all of the Office's financial activity.

- The PO provides a physical environment that facilitates maximum performance by each employee.

Information and Communication

- To run and control its operation, the PO maintains relevant information, both financial and non-financial, relating to external as well as internal events.

- To run and control its operation, the PO maintains relevant, reliable, and timely communications relating to internal as well as external events.

- The PO ensures the forms of communications are broad-based and that information technology management assures useful, reliable, and continuous communications.

Monitoring

- Continuous monitoring occurs during normal operations and includes regular management and supervisory activities, comparisons, reconciliation, and other actions people take in performing their duties.

- The PO conducts separate evaluations that focus directly on the effectiveness of controls at a specific time.

- The PO establishes policies and procedures for ensuring audit and review findings and recommendations are brought to the attention of management and are resolved promptly.