



**EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503**

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MEMORANDUM FOR THE CHIEF FINANCIAL OFFICERS, CHIEF OPERATION OFFICERS, CHIEF INFORMATION OFFICERS, PROGRAM MANAGERS, AND INSPECTORS GENERAL

FROM:

Linda M. Combs
Controller

A handwritten signature in blue ink that reads "Linda M. Combs".

SUBJECT:

Revised Frequently Asked Questions Regarding OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A

Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, defines management's responsibility for internal control in Federal departments and agencies. In December 2004, OMB revised the Circular A-123 and introduced Appendix A, which prescribes a strengthened process to assess the effectiveness of the internal control over financial reporting. On August 22, 2005, we issued the first set of frequently asked questions (FAQs) to provide guidance for the implementation of A-123 requirements.

Based on comments received, we have further revised the FAQs (attachment) to provide additional guidance to the requirements of Appendix A. The attachment, along with the Chief Financial Officers Council's Implementation Guide (http://www.cfoc.gov/documents/Implementation_Guide_for_OMB_Circular_A-123.pdf), are additional resources for facilitating compliance with the A-123 requirements. The frequently asked questions can also be found on the OMB web page at www.whitehouse.gov/omb/financial.

If you have any questions regarding this memorandum, please contact the Office of Federal Financial Management at 202-395-3993.

Attachment

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Attachment

I. General

1. Why did the Office of Management and Budget revise Circular A-123?

Effective internal control is the foundation for timely and reliable financial management information and fundamental to management accountability. The President's Management Agenda (PMA) emphasizes the need for effective internal control to routinely meet accelerated financial reporting goals and have accurate financial information readily available to manage programs. The new internal control requirements for public companies under the Sarbanes-Oxley Act of 2002, P.L. 107-204 (SOX), have also served as an impetus to review existing internal control requirements in the Federal Government.

With these things in mind, in fiscal year 2004 the Office of Management and Budget (OMB) convened a joint Chief Financial Officers Council (CFOC) and President's Council on Integrity and Efficiency (PCIE) committee to review the new internal control requirements for public companies under SOX and determine the appropriateness of these requirements in the Federal Government. The Federal Manager's Financial Integrity Act (FMFIA) and Circular A-123, *Management's Responsibility for Internal Control*, are at the center of internal control requirements in the Federal Government.

The joint CFOC/PCIE committee recommended that Circular A-123 be strengthened to require a more rigorous assessment of internal control over financial reporting. OMB accepted this recommendation and worked closely with the CFOC/PCIE working group to develop the revised circular.

2. What are the major changes?

The revised Circular A-123 requires a strengthened process for conducting management's assessment of the effectiveness of internal control over financial reporting based on widely recognized internal control standards. The strengthened process for conducting and documenting management's assessment of internal control over financial reporting is defined in Appendix A.

Implementing Appendix A requires management to take a proactive approach to assessing and improving internal control effectiveness. The assessment process requires: 1) documentation of the assessment methodology and key processes such that the reader can acquire an understanding of the process flow and controls surrounding the process, 2) direct testing of key controls to determine operating effectiveness, and 3) a new assurance statement for internal control over financial reporting (as a subset of the overall FMFIA assurance statement). The revised Circular emphasizes the need for management

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to integrate its assessment, where possible, with other control-related activities already being performed.

3. What entities are covered under the Appendix A revisions?

The new requirements contained in Appendix A apply to the 24 Chief Financial Officers (CFO) Act agencies. Component units are not required to be assessed separately, but should be included in the agency-wide assessment and assurance statement.

4. What is the effective date?

The revised Circular A-123 is effective beginning in fiscal year (FY) 2006. Agencies should have taken steps in FY 2005 to develop a detailed implementation plan for conducting the assessment process.

The fiscal year 2006 management assurance statement for internal control over financial reporting is required as of June 30, 2006, for inclusion in FY 2006 agency Performance and Accountability Reports (PARs), due 45 days after the end of the fiscal year. For entities that receive opinions on internal control over financial reporting, the fiscal year 2006 management assurance statement will be as of September 30, 2006 to better coincide with the timing of the audit opinion.

II. Planning Management's Assessment

1. How is the Senior Management Council different from the Senior Assessment Team?

The Senior Management Council is responsible for advising the agency head on what deficiencies within the organization may be categorized as material weaknesses and reported externally. Agencies may also use the Senior Management Council to monitor corrective action milestones related to identified deficiencies to ensure resolution occurs in a timely manner. The Senior Management Council may include the Chief Financial Officer, Chief Information Officer, and the heads of other functional areas.

The Senior Assessment Team is a subset of the Senior Management Council under the direction of the Chief Financial Officer. The Senior Assessment Team is responsible for conducting and coordinating the internal control assessment process specifically related to financial reporting.

2. Who should conduct the assessment of internal control over financial reporting?

It is recommended, but not required, that agencies form a Senior Assessment Team to direct the assessment. OMB Circular A-123, Appendix A provides guidance on the

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functions and responsibilities of the Senior Assessment Team. The Senior Assessment Team should be under the direction of the CFO and should include executives from areas responsible for maintaining controls over key processes and systems.

Process owners most knowledgeable about the key processes and systems should be responsible for documenting those processes and systems and identifying key controls. The Senior Assessment Team should then designate individuals to review the documentation and perform tests to verify the controls are operating effectively.

3. What role does the Chief Information Officer (CIO) play in the assessment process?

A senior level representative from the Office of the Chief Information Officer should be a member of the Senior Assessment Team since documenting and assessing information technology (IT) controls is a major component of the assessment process.

4. What is the scope of the assessment of internal control over financial reporting?

Management has discretion in determining both aspects – *breadth and depth* – of the scope of financial reporting. The *breadth* of financial reporting encompasses the specific financial reports that are included within the scope of the assessment. At a minimum, the breadth of financial reporting includes the annual and quarterly entity-wide financial statements and associated notes. Management has discretion to determine what other financial reports are key to the department/agency and expand the scope to include those reports (e.g., SF 133, Report on Budget Execution and Budgetary Resources). The *depth* of financial reporting constitutes the boundaries of where the financial reporting processes meet the operating processes on an entity-wide basis as well as the extent of coverage at the component unit and multiple locations.

5. Does OMB Circular A-123, Appendix A apply to both financial management control and operational program controls?

Although OMB Circular A-123, Appendix A specifically addresses internal control over financial reporting; operational program controls and financial reporting often overlap. Therefore, management must determine which operational program controls have a financial reporting impact and include such controls within the universe of Appendix A activities. In making this assessment, management should consider whether the control in question specifically relates to and impacts the agency's financial reporting.

For example: An agency may award many grants over the course of a year. Operational program controls related to awarding grants would include monitoring, program reports, program audits, and other such operational control activities that ensure that federal monies are being spent as intended. One may consider that these are not necessarily financial reporting controls, but they can be and often times are. To the extent that these

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control activities impact financial reporting, they should be included within the universe of Appendix A activities.

If an agency discovers through the program audit that the monies awarded have not been spent properly, a request is issued to reacquire the money from the grantee. If this occurs, it directly impacts the financial reporting of Accounts Receivable. Therefore, the operational program controls surrounding the determination and recording of federal monies to be returned are, in fact, subject to the assessment process noted under Appendix A of OMB Circular A-123 (see Question 2, Section III – **Testing**). This assessment process is further clarified in the implementation guidance published on the CFO Council website, www.cfoc.gov/.

An *example* of an operational program control that does not directly affect financial reporting might include the results from a program review. An agency awards a grant and is then required, as part of its operational program controls, to review documentation from the recipient to ensure that a specific number of items are achieved or occurred during a specific time period. A summary of the findings related to the report submitted from the recipient is an operational program control, but does not flow into the financial reporting process. Therefore, this operational program control would be exempt from the rigors of the Appendix A assessment process, but still subject to management's assessment of controls as required in the body of A-123.

Based on these examples, most program controls will impact financial reporting in some form; however, operational program controls with non-material impacts on financial reporting could be excluded from the Appendix A assessment.

6. What types of management assurances are needed from component units in a large complex agency?

There is only one management assurance required as part of the PAR submission for Circular A-123, Appendix A, and that is at the department-wide level. The agency head has the flexibility to determine what type or level of management assurance is required from its component organizations. The management assurance required by the agency head should be directly related to the amount of test work performed, as determined by scope, risk, and materiality determinations made by management.

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7. During its assessment, can management rely on SAS 70¹ reports issued by auditors of service organizations used by the agency?

Yes. An agency can leverage SAS 70 reports during the assessment. Management must consider if a Type II SAS 70 report exists and if it is sufficient in scope². Agency management should look at the scope of the SAS 70 report in the context of the overall internal control assessment when considering the nature and type of other assessment activities needed outside of the SAS 70 process. A Type II SAS 70 report is required of all federal entities that cross-service other federal entities per OMB Memorandum M-04-11, *Service Organization Audits* (<http://www.whitehouse.gov/omb/memoranda/fy04/print/m04-11.html>).

8. Is management required to provide absolute assurance of internal control over financial reporting?

No. Management's assurance on internal control over financial reporting represents that management is responsible for the establishment and maintenance of internal controls and that its assessment was conducted in accordance with Appendix A of OMB Circular A-123, and that based upon the results, management can provide *reasonable assurance* that internal control over financial reporting was operating effectively as of the date of the assessment.

9. How should agencies, with previously reported (Financial Statement Audit, FFMIA or FMFIA) material internal control weaknesses, plan their assessment?

As part of the A-123, Appendix A assessment, management must evaluate the corrective actions taken and should assess whether the previously reported (Financial Statement Audit, FFMIA, or FMFIA) material weaknesses continue to exist. In cases where previously reported material weaknesses continue to exist, the interim focus should be on adequately executing corrective actions in areas where controls are ineffective and then identifying significant financial reporting areas where assurance can be provided. If previously reported weaknesses have not been corrected, then the agency would not need to test those controls. However, the agency would need to consider those weaknesses when determining what type of assurance to provide.

¹ A SAS 70 report is an audit report on the internal control over the services provided by a service organization. See AU Section 324, *Service Organizations*, of the Codification of Statements on Auditing Standards.

² Typically a Type II SAS 70 report is not sufficient on its own to satisfy the requirements under the Federal Information Security Management Act (FISMA).

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If management believes that sufficient corrective actions have been completed on previously reported weaknesses, testing of those controls should be included in the scope of the A-123 assessment. In cases where previously reported weaknesses exist, but the agency has developed interim compensating measures that have enabled it to get an unqualified or qualified audit opinion on its financial statements, the A-123 assessment process should document and test those compensating measures used for financial reporting.

III. Testing

1. Do all key controls need to be tested annually?

No. Testing of controls should be based on risk. Once all key controls have been tested once and a baseline established on the operating effectiveness of those controls, not all key controls must be tested every year³. The risk-based approach generally requires that controls are stable, there are no known deficiencies, and that controls will be tested at least every three years. Further, for fully automated controls, management is required to verify that adequate change control procedures are in effect. Management should document its risk-based testing plan and how the above circumstances are met.

2. What is management's responsibility with respect to the type of testing necessary to provide adequate support for its assurance?

There is not a "one size fits all" approach to the type of testing that is required to support management's assurance statement. Management has the best understanding of the agency, its associated risks, and the controls in place to mitigate risk. Therefore, management can and should use discretion when developing the testing approach that is required to support its statement of assurance. Management has the option to use any testing method that is cost effective and does not compromise the integrity of the assessment.

³ FISMA, however, requires annual testing of "...the effectiveness of information security policies, procedures, and practices." See OMB Memorandum M-05-15, FY 2005 Reporting Instructions for the Federal Information Security Management Act and Agency Privacy Management, for additional guidance.

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IV. Requirements for Implementing A-123, Appendix A

1. What are some indicators of compliance with A-123, Appendix A?

The A-123, Appendix A lays out an assessment process that management should implement in order to properly assess and improve internal controls over financial reporting. The assessment process should provide management with the information needed to properly support a separate assertion as to the effectiveness of the internal controls over financial reporting. The indicators that management should consider when implementing the A-123, Appendix A requirements should include but are not limited to:

- Management established an organizational structure to effectively implement, direct and oversee the assessment process. The Circular suggests a Senior Management Council and a Senior Assessment team or equivalent structures. The oversight of the assessment process may also be incorporated into existing offices or functions within the organization that currently monitor the effectiveness of the organization's internal control.
- Management evaluated controls at the entity level and considered the components of internal control as defined in the A-123 and GAO's Standards for Internal Control in the Federal Government (www.gao.gov).
- Management used a reasonable approach to determine the scope of the assessment. The scope of the assessment would include identifying significant financial reports and key process/controls/transactions.
- Management evaluated and documented the key processes and controls as required by A-123, Appendix A. Management also documented its decisions on determining the scope, materiality, testing results, and other significant decisions related to this assessment.
- Management used a reasonable approach to determine what, when, where and how to test the key controls, and the tests and results were properly documented.
- Management used the results of its testing, and considered information gathered during the financial statement audit, to support its conclusion whether internal controls over financial reporting were properly designed and operating effectively.
- Management's assurance statement appropriately describes any scope limitation, and is consistent with the evidence gathered during the testing process, including information gathered during the financial statement audit.
- Management has plans in place and a process to continue assessing controls in accordance with the A-123, Appendix A.

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- Management has a process in place to assure prompt and proper implementation of corrective actions to resolve deficiencies in internal controls, including material weaknesses.

Management of agencies that have pervasive material weaknesses, however, should focus on the remediation of those weaknesses rather than testing internal controls that are known to be ineffective. Therefore, for these agencies, consideration will be given to the plans and implementation of corrective actions to resolve those weaknesses in internal controls.

2. What if an agency is unable to implement the minimum requirements of the assessment process?

Agencies that are unable to fully implement the A-123, Appendix A assessment process in a given year, will need to identify this scope limitation in its annual assurance statement describing the effectiveness of internal control over financial reporting.

Agencies will also need to provide OMB with an updated A-123 assessment plan for the next fiscal year that addresses how and when the limitation will be remedied. A date for this deliverable will be negotiated through the PMA process.

3. What is a scope limitation?

A scope limitation occurs when management is unable to fully implement the assessment process described in A-123, Appendix A in a given year. Where an agency has developed a multi-year plan for implementing the A-123 Appendix A, a scope limitation will occur in each year, until the multi-year plan is fully implemented.

After the key controls have been tested once and a baseline has been established, agencies may rotate the testing of those internal controls (refer to Section III, Testing). Testing the internal controls on a rotational basis would not constitute non-compliance with the A-123 Appendix A.

4. Can an agency have a scope limitation and still be compliant with the A-123, Appendix A?

Yes. OMB realizes that due to the complexity of some agencies, implementing the requirements in the A-123, Appendix A and establishing a baseline may span more than one year. With this realization, an agency will be considered compliant with the A-123, Appendix A if:

- The agency submits a plan that: (i) states why the agency requires more than one year to execute its plan, (ii) provides for identifying, testing, and assessing a significant percentage of its key business processes and controls in each year, (iii)

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demonstrates how the agency will meet the A-123, Appendix A requirements by September 2008, and (iv) is reviewed and accepted by OMB;

- The agency implements their A-123 assessment process in substantial accordance with the OMB-approved plan⁴; and
- The agency head provides an assurance statement that accurately reflects the amount of work completed (e.g., agencies that are implementing a multi-year plan will need to identify a scope limitation) and the results of the assessments performed (e.g., a qualified assurance statement or statement of no assurance as discussed in question 5 below).

For example, Agency B identifies 10 key business processes that are material to its financial reporting. Agency B cannot test all 10 business processes end-to-end in year one and therefore, elects to test 6 of the 10 in the first year. Overall, Agency B should report a scope limitation for its assurance statement on internal control over financial reporting. This scope limitation will result in either a qualified or statement of no assurance depending on the materiality of the scope limitation.

Agency B develops a sufficient plan that includes a full scope test of the four remaining business processes in tandem with risk-based testing on the other 6 in the second year and submits this updated plan to OMB. Agency B accurately reports a scope limitation in its annual assurance in year one. OMB will consider the agency in compliance with Appendix A of Circular A-123.

This provision will sunset after the fiscal year 2008 reporting cycle. Beginning with fiscal year 2009, agencies should have a reasonable baseline established for its key controls, such that a multi-year implementation strategy is no longer necessary. OMB, however, will continue to work with agencies that are challenged by significant and long-term material weaknesses.

5. Can an agency have a scope limitation and still provide an unqualified assurance statement as to the effectiveness of the internal controls over financial reporting?

No. Agencies that report scope limitations should provide a qualified or statement of no assurance as to the effectiveness of the internal controls over financial reporting. Management must assess the materiality of the effect of the scope limitation and determine the appropriate type of assurance to be reported by the agency head.

⁴ Agencies that are planning a full scope assessment process in the initial year will have until June 1, 2006 to submit a plan to OMB, if they determine they are unable to fully implement within the initial year as planned.

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V. Reporting and Corrective Action Plans

1. How should the new assurance statement on internal control over financial reporting be reported in the PAR?

The annual assurance statement is reported in the PAR in the Management Discussion & Analysis (MD&A) section. This assurance statement is a subset of the FMFIA assurance statement currently required. The assurance statement (overall assurance with a separate reference to internal control over financial reporting) should be reported in a separate section in the MD&A section entitled "*Management Assurances.*" A summary of material weaknesses and corrective actions should be included in an exhibit accompanying the assurance statement. If the material weakness has been corrected prior to PAR issuance, resolution can be reported if there has been time to perform adequate testing of the control.

2. What is the period covered by the assessment of internal control over financial reporting?

For entities that do not receive an opinion⁵ on internal control, management's assurance statement is based on the controls in place as of June 30. The year-end financial reporting controls in place for the prior fiscal year may be included in the current year's assessment, if the control environment has remained fairly stable. The assurance statement included in the annual Performance and Accountability Report (PAR) will report the agency's assurance status as of June 30. In addition, the agency must report any material updates through the publication date of the PAR. This would include consideration of any items covered in the auditor's report that were not in the June 30 assurance statement or possibly the completion of corrective actions and testing of items that were identified as of June 30.

For those entities that receive an opinion on internal control, management's assurance is based on the controls in place as of September 30 to coincide with the audit and should reflect audit findings as appropriate.

3. What period is covered by the initial assurance statement prepared as of June 30, 2006?

The assurance statement for fiscal year 2006 will cover controls in place from October 1, 2005, to June 30, 2006. During this initial year, agencies have alternatives for assessing

⁵ As of February, 2006, only the Department of Homeland Security is required to have an opinion on internal control. However, an agency may elect to have an audit of internal control. In addition, OMB reserves the right to require an agency to receive an opinion on internal control if necessary.

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the year-end controls, such as testing design effectiveness and/or testing operational effectiveness through simulation or other procedures.

4. Should the assurance statement provided as of June 30 be updated prior to being reported in the PAR in November?

Yes, changes in the control environment and effectiveness of controls may occur between June 30 and the end of the fiscal year. For example, management may implement new controls to address a material weakness reported as of June 30. In this example, management may perform additional procedures from June 30 to September 30 that validate the effectiveness of a new control and resolution of a material weakness previously reported. In this case, the material weakness is still reported in the PAR, but an explanation is provided indicating the weakness has been corrected and the new controls validated.

Similarly, while the testing of year-end controls is part of the next year's assessment, management's or an independent auditor's testing at year-end may reveal a material weakness that was not reported as of June 30. In this case, management should include the new material weakness in the updated assurance statement reported in the PAR.

5. What are the requirements for developing corrective action plans to remediate material weaknesses?

Corrective action plans are required for all material weaknesses, and progress against plans should be periodically assessed and reported to agency management. A summary of the corrective action plans for material weaknesses shall be reported to OMB and the Congress through the PAR. The summary discussion shall include a description of the material weakness and status of corrective actions with target completion dates. Corrective actions will continue to be monitored as part of the PMA Improving Financial Performance scorecard.

VI. Management and Independent Auditor Interaction

1. How does the Circular A-123 internal control assessment process relate to the annual financial statement audit?

Management's documentation of controls, annual assessment, and any resultant corrective actions can have a positive effect on the annual financial statement audit. An audit of a well-documented system that is routinely monitored and adjusted by management will positively impact on the auditor's consideration of risk, and thereby, make the financial audit easier to plan and conduct.

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Conversely, the insights of the independent auditor into management's systems and the operating effectiveness of those systems can aid management in designing the appropriate nature, timing, and extent of testing required for its assessment.

2. Can auditors share documentation developed as part of the independent audit process?

Yes, certain information can be helpful to supplement and validate management's documentation. Having accurate and consistent documentation of key processes supports both management's assessment and the independent audit. Leveraging documentation activities can strengthen management and auditor understanding of the agency's control activities. However, receipt of information from an independent auditor does not remove management's responsibility for internal control documentation, design, adequacy (both design and operating effectiveness), and related testing or conclusions in support of management's assurance statement.

3. What recommended areas should be discussed with the Inspector General or outside auditors?

It is highly recommended that management consult with the agency Inspector General (IG) and independent financial auditors during key phases of the assessment. It is most critical to discuss significant planning decisions relating to:

- Scope of the work;
- Materiality and risk considerations;
- Identification of key processes and controls;
- Priority of key processes to test;
- Sampling methodology, as appropriate; and
- Timing of test-work to be performed.

4. What is an appropriate role for the agency Inspector General to play in the assessment process?

The IG should participate in an advisory capacity to the extent the IG feels its independence will not be compromised, as permitted under GAO Government Auditing Standards Chapter 3. The requirements of Circular A-123 are directed to agency management. The assessment process for internal control over financial reporting must be planned, defined, performed and reported on by management; not the IG or independent auditor. However, it is appropriate for IGs and other independent auditors to be consulted in regard to key management decisions during the planning phase of the assessment and during the evaluation phase in preparation for the final assurance reporting.

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Similarly, there may be efficiencies that could be achieved between work done by management in conducting their assessment (e.g., up-to-date documentation of key processes and controls to speed the audit) and work performed by the IG or independent auditor in conducting the financial audit (e.g., sharing with management cycle memos or working papers as a starting point for management to document or update its documentation of its key processes and controls). To ensure good communication between management and independent auditors, it is appropriate for a representative from the agency's Office of Inspector General to be included as an ex-officio member of the Senior Assessment Team.