U.S. Department
of Transportation

**Maritime
Administration**

GUIDE FOR CONDUCTING

INTERNAL CONTROL REVIEWS

MARITIME ADMINISTRATION

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Maritime Administration
Guide for Conducting Internal Control Reviews

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Guide for Conducting Internal Control Reviews

Section 1. Purpose

This paper is issued pursuant to MAO 900-3, "Internal Control Systems," to provide guidance for conducting internal control reviews of MARAD programs and activities.

Section 2. Introduction

2.01 Strong systems of internal accounting and administrative control can help to prevent waste, loss, unauthorized use, or misappropriation in Federal Government operations. Internal control is the plan of organization and all of the methods used within a Federal agency to safeguard its resources, assure the accuracy and reliability of its information, assure adherence to applicable laws, regulations and policies, and promote operational economy and efficiency.

2.02 An internal control system is the totality of the organization, methods, and measures used to achieve internal control objectives. It is an integral part of the programs and functions performed by the agency and the systems used to operate these programs and functions. Thus, internal control is the responsibility of the same individuals responsible for operating the programs and functions.

2.03 In addition to the management and economic value of internal control, there are certain legal requirements that must be considered. These are 31 U.S.C. 3512, which requires the head of each Federal department and agency to establish and maintain adequate systems of accounting and internal controls, and OMB Circular No. A-123, "Internal Control Systems," which prescribes standards and policies for internal controls and directs each agency to review and update its internal control system on an ongoing basis. Also, the Federal Managers' Financial Integrity Act of 1982 (the Act) amends 31 U.S.C. 3512, requires the head of each agency to report to the President and the Congress annually on the status of his or her agency's system of internal control, and requires the General Accounting Office to prescribe standards for internal controls in the Federal Government. These standards apply to both financial management and program performance areas in the executive departments and agencies.

2.04 An efficient and effective way to approach the review and evaluation of internal control is comprised of seven phases:

1. Organizing the process. This includes a determination as to the information and assurances to be provided to the agency head to enable the annual statement to be made to the President and the Congress; the assignment of responsibilities for planning, directing, and controlling the evaluation process throughout the agency; and the development of an information system that provides a tracking of the status of the evaluations and corrective actions as well as other pertinent information necessary to manage the overall process and facilitate preparation of the annual report.

2. <u>Segmenting the agency into organizational components, and then
   identifying the programs and administrative functions conducted in
   each component.</u> For example, the Maritime Administration can be seg-
   mented into the individual Associate Administrator's organizations
   and independent offices at headquarters in Washington, D.C., and the
   individual Region Offices and the U.S. Merchant Marine Academy in the
   field, etc. The Associate Administrator for Maritime Aids organiza-
   tion, in turn, could be segmented into the Office of Ship Financing,
   Office of Marine Insurance, etc.; or into administrative functions
   such as eligibility determination systems, benefit payment systems,
   quality control, etc.

3. <u>Assessing the vulnerability</u> to waste, loss, unauthorized use, or
   misappropriation of the funds, property, or other assets within each
   component and deciding which are the most vulnerable. This is done
   by identifying the factors that create an inherent riskiness in the
   function, considering the operating environment in which the function
   is performed, and preliminarily evaluating whether safeguards exist
   to prevent waste, loss, unauthorized use, or misappropriation from
   occurring.

4. <u>Developing plans and schedules for the performance of internal control
   reviews and other actions</u>, based on an evaluation of the results of the
   vulnerability assessments and other considerations (management priori-
   ties, resource constraints, etc.), and in such a manner as to provide
   that internal controls in those programs and administrative functions
   deemed to be the most vulnerable, as well as those deemed to be less
   vulnerable, are evaluated and improved as necessary to ensure a strong
   system of internal control.

5. <u>Reviewing the internal controls</u> for the selected programs and adminis-
   trative functions, determining whether adequate control objectives have
   been established and control techniques exist and are functioning as
   intended, and then developing recommendations to correct weaknesses in
   either the design or functioning of the internal control system.

6. <u>Determining, scheduling, and taking the necessary corrective actions</u>
   for improving internal controls on a timely basis. Included in the
   determination should be an analysis to assure that the expected bene-
   fits to be obtained will outweigh the costs of any improvements made.

7. <u>Preparing the annual statement to the Secretary of Transportation</u> on
   the status of the agency's system of internal control, as required
   by DOT Order 5100.4A, Department of Transportation Internal Control
   Systems, and other applicable directives.

The above process is not an attempt to evaluate discretionary policy
decisions. Rather, the evaluation process begins at the point at which
a program or function has been authorized by the policy-level official
having authority to do so, and focuses on the steps involved in the
operation of the program. For example, the review of a program should
not include an evaluation of whether the eligibility criteria are consis-
tent with the statute and its legislative history. Instead, the review
should evaluate whether the operation of the program is consistent with

the criteria and thus there is reasonable assurance that obligations and costs are in compliance with the applicable law; funds, property, and other assets are safeguarded; and revenues and expenditures are properly recorded.

Section 3. Internal Control Reviews

3.01 An internal control review is a detailed examination of a system of internal control to determine whether adequate control measures exist and are implemented to prevent or detect the occurrence of potential risks in a cost-effective manner.

3.02 The six recommended steps for an internal control review are:

1. Identification of the event cycles

2. Analysis of the general control environment

3. Documentation of the event cycle

4. Evaluation of the internal controls within the event cycle

5. Testing of the internal controls

6. Reporting the results of the internal control reviews

3.03 <u>Identification of the Event Cycles</u>

1. The first step in conducting an internal control review is to identify the event cycles in the program or administrative function selected for review. Event cycles are the processes used to initiate and perform related activities, create the necessary documentation, and gather and report related data. In other words, an event cycle is a series of steps taken to get something done. Each program and administrative function performed within an agency or agency component contains one or more event cycles. For example, a program could contain the following event cycles: application receipt and processing, eligibility determination, information processing and recordkeeping, payment, and monitoring. The event cycles for an administrative function such as payroll could include preparation and verification of T&A reports, review and recording of the reports, maintenance of accurate leave balances, and issuance of checks in the proper amounts to employees. The sources of information for developing a list of event cycles include appendixes B and B-1 of OMB's "Internal Control Guidelines" document or similar material published by GAO, professional associations, and private organizations; the vulnerability assessment for the program/function; legislation; regulations; policy statements; procedures manuals; management interviews; etc. Exhibit 1 provides a form on which the cycles may be listed.

2. A determination must then be made as to which event cycle(s) are to be reviewed (documentation supporting this decision should be maintained). The results of the vulnerability assessment should be helpful in making this determination, with areas identified as most vulnerable being given the highest priority.

3.04 Analysis of the General Control Environment

The environment in which the event cycle operates has a major impact on the effectiveness of internal control. Therefore, the second step of an internal control review is an evaluation of the general control environment, i.e., the management attitude, organizational structure, personnel, delegation and communication of authority and responsibility, policies and procedures, budgeting and reporting practices, organizational checks and balances, etc. The analysis of the general control environment performed for the vulnerability assessment can be referred to and updated.

3.05 Documentation of the Event Cycle

The third step is to document the event cycle. This is accomplished by interviewing the persons involved in the cycle, reviewing existing documentation, observing the activity, and then preparing either a narrative explanation or a flow chart, accompanied by pertinent narrative information in sufficient detail to permit an in-depth analysis of the existence and adequacy of internal controls. The documentation should identify such things as the procedures, the personnel performing the procedures, and the forms and records developed and maintained.

Regardless of the method used, it is advisable to review the completed documentation with the persons providing the information, and, if necessary, track one or two transactions through the process. Both procedures will assure that the documentation and the understanding of the cycle are accurate.

3.06 Evaluation of the Internal Controls Within the Event Cycle

The fourth step in the process is to evaluate the event cycle by reviewing the documentation and deciding whether the system, at least as defined, is sufficient to provide reasonable assurance that obligations and costs are in compliance with applicable law; the agency's funds, property, and other assets are properly safeguarded; and the revenues and expenditures are properly recorded to permit the preparation of reliable financial and statistical information. This is done by:

1. Ascertaining the control objectives for the event cycle. Control objectives are desired goals or conditions for a specific event cycle that reflect the application of the overall objectives of internal control to that specific cycle. If control objectives are achieved, the potential for the occurrence of waste, loss, unauthorized use, or misappropriation is significantly decreased.

    (1) The control objectives for an event cycle should be written. This documentation should be reviewed to determine whether the list of objectives for each event cycle is complete, logical, and relevant to the event cycle. If the control objectives are not adequately documented, such documentation should be developed and maintained as part of the overall documentation of internal controls.

(2) Appendixes B and B-1 of OMB's "Internal Control Guidelines" document suggest appropriate control objectives for some common event cycles. Similar lists can be obtained from the General Accounting Office, professional associations, and private organizations' publications.

2. Examining the documentation and ascertaining whether appropriate internal control techniques are in place to enable the control objectives to be met in an efficient and effective manner. Internal control techniques are the processes or documents that enable the control objectives to be achieved.

   (1) Control techniques should be defined in writing. This documentation should be reviewed to determine whether it provides reasonable assurance that the control objectives can be met in a consistent, efficient, and effective manner. If the control techniques are not adequately documented, such documentation should be developed and maintained as part of the overall documentation of the internal control.

   (2) The relationship between the control objectives, internal control techniques, and the inherent risks in an event cycle cannot be overemphasized. Control objectives are established because a risk exists; internal control techniques are implemented to prevent the specific risk from occurring. For example, a payroll system contains the risk of people getting paid for time not worked. An appropriate control objective would be that payments are made only in return for services. An internal control technique could be that timesheets include approval by a supervisor that the payment made is only for services actually performed.

   (3) It is important to remember that there are inherent limitations that can constrain an agency's efforts to maintain effective internal control. Examples include budget constraints, statutory or regulatory restrictions, staffing limitations, and other priorities. These constraints should be considered when evaluating the appropriateness of the control objectives and internal control techniques.

3. Identifying whether there are any internal control techniques that are excessive, thereby creating inefficiencies and unnecessary costs.

4. Exhibit 2 may be used for documenting the information obtained in 1, 2, and 3 above.

The results of this process are an identification of (a) necessary internal control techniques (whose functioning has to be tested, as discussed in the next section); (b) control objectives for which the control techniques are not adequate (weak) and system corrections must be made; and/or (c) control techniques that are unnecessary (excessive) and can be eliminated.

3.07 Testing of the Internal Controls

The fifth step in an internal control review is the testing of the necessary control techniques to determine whether such controls are functioning as intended. This may be done by selecting a sample of transactions and reviewing the documentation for those transactions, as well as making other observations and inquiries, and ascertaining whether the specified techniques are satisfactorily employed. Various sampling procedures may be useful for enhancing the effectiveness of this process. The testing of the ADP systems may often require the use of advanced review procedures.

1. Sometimes a specified control technique will appear to be inadequate for a given condition or will not be functioning properly. In those instances, the reviewer should evaluate whether personnel are compensating for the shortcoming with other safeguards, or whether compensating controls exist in interrelated systems not subject to the review.

2. The reviewer should complete this testing step by noting any necessary control techniques not functioning as intended or not compensated for. He or she should also consider how such shortcomings should be addressed, i.e., by instituting new controls, improving existing controls, or accepting the risk associated with the shortcoming. A form which may be used for such notations is presented in Exhibit 3.

3.08 Reporting the Results of the Internal Control Reviews

1. The final step in an internal control review is documenting and reporting the results. These reports should initiate corrective action and are prepared for the managers of the programs and administrative functions reviewed and other line managers. They may be written or oral and should identify weaknesses within the system and recommendations as to how any weaknesses found can be corrected. (Oral reports should be memorialized in memos to the file.) Recommendations for possible improvements in the economy and efficiency of the internal controls should also be made, if appropriate.

2. More specifically, the reports should focus, as appropriate, on the extent to which:

    (1) The general control environment may be inadequate to provide the necessary atmosphere for the appropriate functioning of specific controls.

    (2) Necessary control techniques are nonexistent or inadequate.

    (3) Necessary control techniques are not functioning as intended.

    (4) Control techniques are excessive, thereby fostering a lack of economy or creating inefficiencies.

    (5) Executive, legislative, or other management requirements are excessive, thereby creating inefficiencies.

3. In evaluating possible improvement actions, consider the costs and
    expected benefits of changes in order that control objectives can be
    achieved in a cost-effective manner. While it is sometimes difficult
    to determine the exact costs and benefits of suggested improvements,
    it is desirable at least to estimate these amounts so that controls
    are not instituted that cost more than they save. Also consider any
    inherent budgetary, staffing, or other restraint when developing
    possible improvement actions.

U.S. Department of Transportation
Maritime Administration

Agency Component: _____

List of Event Cycles Within Programs
and Administrative Functions

Program/Administrative Function - _____

Event Cycles	Comments

Prepared by _____   Date _____

Reviewed by _____   Date _____

EXHIBIT 1

U.S. Department of Transportation
Maritime Administration

Agency Component: _____

List of Internal Controls

Program/Administrative Function - _____

Event Cycle - _____

Control Objectives	Control Technique	Necessary (N) Weakness (W) Excessive (E)	Comments

Prepared by _____ Date _____

Reviewed by _____ Date _____

EXHIBIT 2

U.S. Department of Transportation
Maritime Administration

Agency Component: _____

Tests of Internal Controls

Program/Administrative Function - _____

Event Cycle - _____

Control Objective - _____

Necessary Control Techniques	Functioning (Yes or No)	Adequate (Yes or No)	Comments and Recommendations

Prepared by _____   Date _____

Reviewed by _____   Date _____

EXHIBIT 3