

OMB A-123: Recent Developments

MANAGING RISK IN THE FEDERAL GOVERNMENT

THE ROLE OF OMB CIRCULAR A-123

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Required Reading

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THE ROLE OF OMB CIRCULAR A-123

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Office of Management and Budget (OMB) Circular A-123 *Management's Responsibility for Internal Control* is implementing guidance for the Federal Managers Financial Integrity Act (FMFIA) of 1982. FMFIA requires federal agencies to maintain administrative and financial controls and capable and secure financial systems. FMFIA further requires the agency head to assert annually on the effectiveness of internal controls within their federal agency or department. Appendix A of Circular A-123 takes this requirement one step further and requires a separate management assurance statement on internal control over financial reporting. The overarching purpose of the Circular is to ensure that federal agencies have well-controlled and effective processes in place to achieve their objectives, whether those objectives are effective and efficient operations, accurate reporting or compliance with laws and regulations; essentially, implementing internal controls to manage and mitigate risks to achieve the agencies operational, financial and compliance driven objectives.

Overview of Circular A-123 and its Appendices

Circular A-123 has a number of separate appendices that have been developed to emphasize internal controls in specific areas. The body of the Circular itself incorporates the GAO *Standards for Internal Control for the Federal Government* (Green Book) as the standards that federal agencies are required to follow in establishing internal control frameworks.

Appendix A of Circular A-123 specifically addresses financial reporting. Appendix A is the most rigorous of the appendices in requiring a separate assurance statement by the agency head on internal control over financial reporting and documented annual testing of internal controls to support management's determination. Appendix A is modeled after the requirements for large public companies in the Sarbanes Oxley Act of 2002, with one significant exception. Public companies are required to obtain a separate audit opinion over internal control over financial

reporting; federal agencies are not subject to this same requirement under FMFIA or Circular A-123, Appendix A.

Appendix B of Circular A-123 requires special procedures and controls surrounding government charge card programs, such as travel and purchase cards. This was done to emphasize the elevated risks in these areas and to consequently, require additional controls that federal agencies must have in place.

Appendix C of Circular A-123 was developed as a component of the implementing guidance to the Improper Payments Elimination and Recovery Act of 2010. Improper payments Government-wide are currently about \$106 billion¹. Appendix C acknowledges payment accuracy as a high risk area Government-wide and identifies specific requirements for agencies to conduct specific risk assessments, monitor payment accuracy through statistically-based payment accuracy rates, report payment accuracy and implement corrective actions.

Just added in 2013, Appendix D of Circular A-123 is the most recent appendix effective for fiscal year FY2014. Appendix D outlines the compliance requirements for the Federal Financial Management Improvement Act (FFMIA) of 1996. Specifically, the provisions within FFMIA requiring federal agencies to maintain financial systems that are secure and possess certain elements of financial reporting functionality that enhance data reliability. Appendix D replaces hundreds of specific requirements for which agencies previously had to “check the box” in determining compliance. Appendix D takes a more streamlined and outcome-based approach, leveraging widely reported higher-level indicators contained predominately in an agency’s independent audit report such as agencies’ ability to obtain an unmodified annual audit opinion on the accuracy of their financial statements and the existence of material weaknesses within the auditor’s report on internal control. Appendix D rescinds OMB Circular A-127, *Financial Management Systems* and includes a compliance matrix to assist a compliance determination.

How Circular A-123 Has Been Implemented

There has been a steady increase in focus and effort related to internal control over the last 10 years. Prior to 2004, the implementation of FMFIA in some agencies had become more of a coordination process than a substantive assessment of internal control effectiveness backed by a meaningful process and supporting data. With the issuance of Appendix A in December 2004 and the requirement for a separate management assurance statement over internal control

¹ www.paymentaccuracy.gov

over financial reporting, a more rigorous process was required to support the determination that controls were operating effectively, at least in the area of financial reporting.

Appendix A, which addresses financial controls, requires a multi-phased process to assess risks and materiality, identify and document key internal controls and related processes, perform testing of controls, report results and monitor corrective actions. This more rigorous process was also intended to be integrated with related existing assessments and to have a synergistic relationship with the financial statement audit. The results of Appendix A's focus on financial controls can be seen in the decline in number of material internal control weaknesses reported by independent financial statement auditors of federal agencies. In 2005, 48 material weaknesses were reported by the independent auditors of the 24 major federal agencies². In 2013, that number has been reduced to 29³.

However, overall implementation of Circular A-123 has been inconsistent and not all agencies have achieved the goal of a proactive, integrated and efficient internal control program. While the issuance of related requirements in various appendices was intended to point out the relationship of the specific new requirements to internal controls, these and other related requirements have been implemented in a very "stovepiped" fashion. Frequently, the linkage and connections between the individual requirements, other related initiatives and the overall agency internal control framework are not fully recognized. Nor, anecdotally, has there been significant efficiencies realized, across-the-board, in terms of leveraging and integrating similar processes such as the financial statement audit.

Similarly, on the program side, agencies often have separate programs in place to evaluate program effectiveness and monitor program execution. These evaluations may or may not entail a methodology or approach where key controls underlying program performance are identified, documented and evaluated, such as required for financial controls under Appendix A. Across the spectrum of program operations and financial controls, not enough attention has been given to establishing an enterprise-wide risk-based approach to aligning internal control activities (with risk levels) and assessing internal control effectiveness.

² "Federal Financial Management Report 2006"

http://www.whitehouse.gov/sites/default/files/omb/financial/2006_report.pdf

³ U.S. Government's Fiscal Years 2013 and 2012 Consolidated Financial Statements, Management's Discussion and Analysis Section <http://www.gao.gov/assets/670/661234.pdf>

Challenges Ahead and New Requirements

Across the federal government, risk management and internal control challenges exist in a number of broader financial and program areas such as payment accuracy/improper payments and financial reporting as well as in an array of individual programs, for example, where breakdowns have recently occurred, such as appropriate conference spending, communication of policies and procedures and performance reporting. The lack of a systematic enterprise-wide process to identify and manage these and other risks is one of the most significant management challenges faced by agencies within the federal government. This overarching comprehensive risk-based process must be an integral part of an internal control program, since internal controls are the process that provide reasonable assurance that desired operational, reporting, and compliance outcomes are achieved.

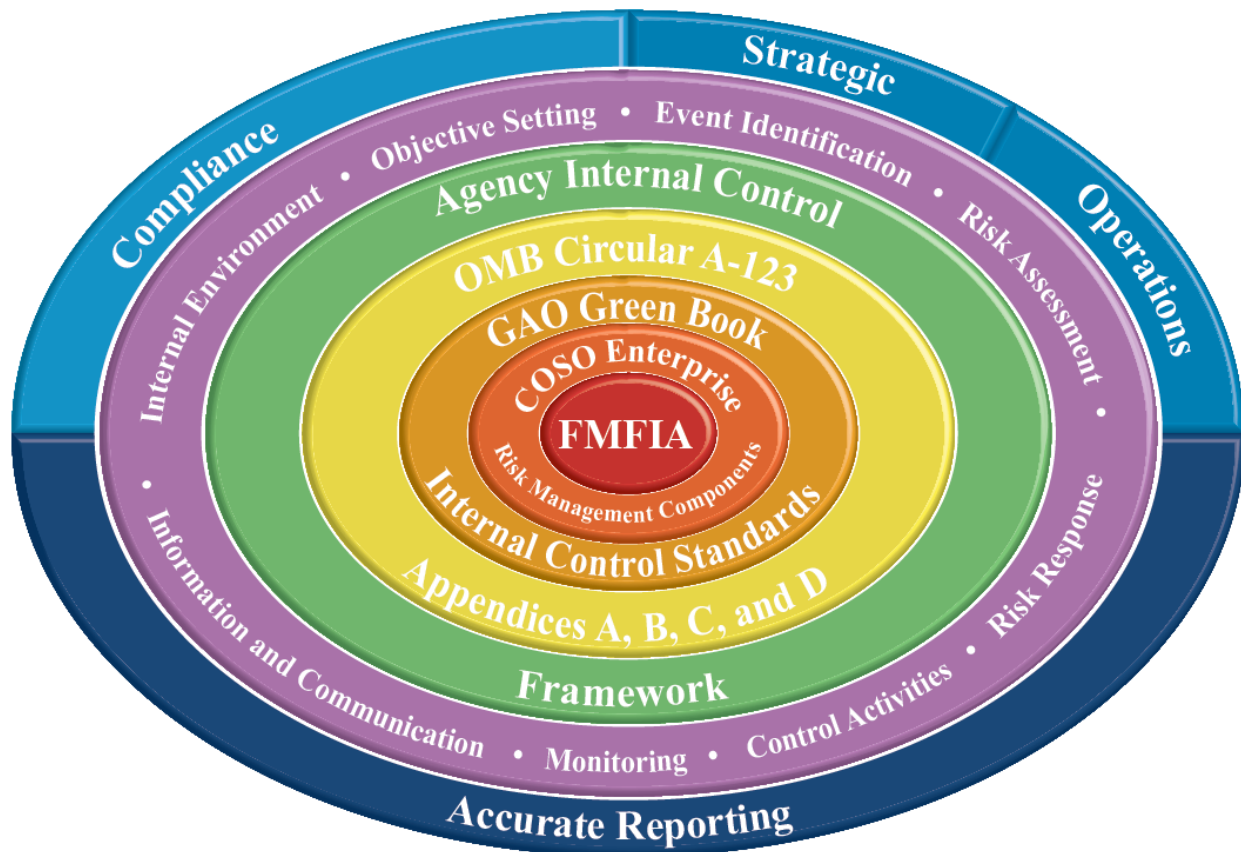
As discussed above, Circular A-123 defines the GAO Green Book as the standards that federal government agencies must follow to maintain effective internal control. The GAO Green Book is currently being revised, and has recently gone through a public exposure period. The anticipated revisions are intended to harmonize the internal control standards federal government agencies must follow with the Committee of Sponsoring Organizations (COSO) internal control standards that private industry follows. While the standards themselves are unchanged, the Green Book will now include underlying “attributes” within each standard that provide further guidance on achieving compliance and effective internal control. It is yet to be seen what the effect will be on federal agencies, but proactive internal control program managers will want to complete a gap analysis between their current systems and process and the new guidance within the standards to make their own assessment of compliance.

As discussed above, Appendix D is the most recent addition to Circular A-123, being issued in 2013 and effective for FY2014. Appendix D implements guidance for Section 4 of the FMFIA which requires agencies to have secure and compliant financial management systems and annually assert to their effectiveness in the agency head’s annual overall assurance statement on internal control effectiveness. Appendix D also outlines the process for assessing compliance with a related requirement contained in the FFMIA. The FFMIA, among other things, requires agencies to maintain functionally capable, secure and complaint financial management systems and for both management and the agency Inspector General to annually report on compliance. While it is too early to tell whether the new guidance will resolve those few cases where management and the IG determinations vary, what Appendix D does do is replace a lengthy and burdensome process with a more outcome-oriented set of compliance indicators. The compliance indicators are well recognized and easy to identify, such as the existence of material weaknesses in the agency’s independent auditor’s report, among others.

On May 9, 2014, the President signed the Digital Accountability and Transparency Act (DATA Act) into law. The DATA Act requires Treasury and OMB to develop standard data standards for federal agencies. It also requires that agencies begin to report more spending information on USASpending.gov. This model is similar to the process and reporting done under the American Recovery and Reinvestment Act (ARRA) a few years back on Recovery.gov. Data integrity issues have been identified with information reported on Recovery.gov and USASpending.gov in the past. As the DATA Act is implemented, it will be important for agencies to incorporate the systems, processes and controls related to this process into their internal control framework. Hence, documenting key control gaps, filling the gaps, and testing effectiveness of the controls will be critical to reduce the risk of inaccurate data being reported.

To address these and other challenges, it is important to keep in mind that they can all be addressed within the context of one agency-wide internal control framework. The illustration below takes this one step further and shows the overlapping relationship underlying an agency's implementation of Enterprise Risk Management (ERM).

Enterprise Risk Management Relationships with Other Standards, Guidance, and Objectives



Too often, when a new requirement is issued, responsibility is assigned and someone is sent off on their way to set up a process to comply. This leads to a lack of understanding of internal control on behalf of program offices and a poorly integrated web of internal control activities across an agency. An appropriate governance structure, an inclusive and meaningful risk-assessment, a sound methodology and approach for identifying and assessing internal controls and a culture of transparency that includes a willingness to address issues that arise, can help to address these challenges.

Evolving to a Better Approach

Evolving risk management and internal control to a more meaningful model and approach within the federal government is something OMB has expressed an interest in addressing in an updated Circular A-123. To that end, there are a number of issue areas that have been raised representing opportunities to move Circular A-123 and other guidance in a direction to facilitate a more comprehensive and integrated approach to risk management and internal controls. The chart below lists these areas of opportunity along with suggestions for ways they could be addressed in updated guidance.

Evolving Risk Management and Internal Control In the Federal Government Areas of Opportunity in Updating Circular A-123

Area of Opportunity	Approach
Broadening risk assessment	Risk should drive internal control activities and the assessment of effectiveness. Greater emphasis needs to be on enterprise-wide risk assessment, keeping in mind the three focus areas of internal control identified in the GAO standards: program operations, reporting and compliance. Risk assessments should drive the level of effort within each of these areas.
Integrating internal control activities	Greater emphasis needs to be placed on integrating internal control activities within one framework. Separate assessment, monitoring, or reporting for example in the areas of charge cards, improper payments or spending reporting accuracy, need to be approached in an integrated way within the context of an agency's overall internal control framework and the GAO Green Book standards to achieve greater efficiency and effectiveness.
Assessing program controls with a similar rigor as financial controls	Much of the emphasis over the last near decade has been on documenting and testing in the area of financial controls (Appendix A). As a result, many agencies have a process in place to assess financial risks, identify and

	document key controls, assess their effectiveness, report results and monitor corrective actions. This systematic approach needs to be leveraged in the area of program operations.
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Conclusion

Internal control has improved considerably within most federal agencies. Many agencies have used the Circular A-123 Appendix A process to assess and improve internal controls using a risk-based formula similar to an independent financial auditor. This in turn, has allowed some agencies to achieve and sustain accurate financial data, favorable audit opinions and fewer reported financial control deficiencies. While financial controls have improved from this approach, no similar systematic process exists for assessing the program controls. The control activities and processes that do exist are often uncoordinated and not based on an enterprise-wide risk assessment.

Changes are underway at GAO to update the Green Book standards. Broadly, the standards are being updated to harmonize with similar COSO standards for private companies. Underlying these changes, the standards will likely provide greater depth in explaining each internal control standard and modernize their application to other types of reporting and areas. OMB anticipates making similar conforming updates to Circular A-123 and going further to emphasize ERM. GAO has defined internal control as a process to provide reasonable assurance that programs are efficient and effective, reporting is accurate and compliance with laws and regulations is achieved. The time has come for internal controls to evolve beyond financial controls into a broader and more comprehensive risk management framework.