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IMPROVING INTERNAL CONTROLS: A REVIEW OF CHANGES TO OMB CIRCULAR A–123

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, FINANCE, AND ACCOUNTABILITY

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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IMPROVING INTERNAL CONTROLS: A REVIEW OF CHANGES TO OMB CIRCULAR A–123

WEDNESDAY, FEBRUARY 16, 2005

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
FINANCE, AND ACCOUNTABILITY,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2247, Rayburn House Office Building, Hon. Todd Russell Platts (chairman of the committee) presiding.

Present: Representatives Platts, Foxx, Towns, and Maloney.

Staff present: Mike Hettinger, staff director; Dan Daly, counsel; Tabetha Mueller, professional staff member; Jessica Friedman, legislative assistant; Nathaniel Berry, clerk; Adam Bordes, minority professional staff member; and Jean Gosa, minority assistant clerk.

Mr. PLATTS. A quorum being present, this hearing of the Government Reform Subcommittee on Government Management, Finance and Accountability will come to order.

When accounting scandals shook the U.S. economy earlier this decade, Congress responded by placing stringent new accounting requirements on publicly traded companies. The legislation known as Sarbanes-Oxley put responsibility for financial information squarely in the hands of managers. To ensure that investors could rely on financial reports, Sarbanes-Oxley required companies to document the safeguards they have in place to prevent errors or fraud, commonly known as internal controls.

Internal controls are the checks and balances that help managers detect and prevent problems. They can be as simple as computer passwords or having a manager sign off on a time sheet or as complex as installing software to track spending and detect spikes that signal trouble. Internal controls provide a foundation for accountability, and while they are important in the private sector, sound internal controls are imperative in Government. Public trust depends on nothing less.

Glaring internal control problems in the Federal Government have made headlines recently from the Office of Management and Budget's reporting of $45 billion in mistaken payments throughout Government to soldiers being paid incorrectly while serving in harm's way. When audits revealed egregious internal control problems at the Department of Homeland Security, this subcommittee proposed and enacted legislation to require the Department to take responsibility for improving internal controls and to have an auditor attest to those improvements.

In light of this legislation and the standards for the private sector under Sarbanes-Oxley, OMB reexamined controls for Federal agencies. I want to applaud this administration for this forward looking action and for employing a collaborative approach using information gleaned from a committee of agency chief financial officers and inspector generals and working with the Government Accountability Office.

As a result of this collaboration, the new guidance was issued in December of last year. Like Sarbanes-Oxley and the requirements at DHS, the revised guidance puts responsibility on agency management and clearly defines the steps that need to be taken and documented to ensure that internal controls are sound. This hearing will look at what prompted these changes and how they will impact agency management.

We are pleased to have a distinguished panel of witnesses with us here today who have played an instrumental role in developing these new guidelines. We have the Honorable Otto Wolff, CFO and Assistant Secretary for Administration at the Department of Commerce and a member of the CFO Council; the Honorable Chris Burnham, Acting Under Secretary for Management, Assistant Secretary for Resource Management and CFO at the U.S. Department of State and a member of the CFO Council; and the Honorable Jack Higgins, Inspector General at the U.S. Department of Education and a member of the President's Council on Integrity and Efficiency.

Mr. Jeff Steinhoff, Managing Director of Financial Management and Assurance at the U.S. Government Accountability Office, also joins these administration witnesses. We are grateful for your appearance here today and know you've done a lot of legwork leading up to this hearing and look forward to hearing your testimonies as well.

I would now like to recognize our ranking member, the gentleman from New York, Mr. Towns, for the purpose of an opening statement.

Mr. TOWNS. Thank you very much, Mr. Chairman. Let me thank you for holding this hearing on OMB's recent amendments to its guidance on agency internal controls.

Following last week's insightful hearing on the state of our Government's financial position, I believe it is timely for our subcommittee to address the issue of internal controls as they relate to improving efficiency and accountability throughout the Federal Government. The need for adequate internal controls in governing the financial and operational components of our agencies has never been greater as the burden of both Federal budget deficits and improper payments diminish the success of many programs. Such concepts are not foreign to us, as recent private sector accounting scandals have forced Congress to reexamine issues of accountability and transparency in the name of protecting consumers and investors.

From this perspective, it is only logical to pursue policies that make the Federal Government more accountable to Congress and taxpayers, just as the private sector must be more accountable to its shareholders and consumers. Today we are reviewing what appears to be the first step in the process as we hear from our panel

about recent amendments made to Circular A–123. In conformity with the Federal Managers Financial Integrity Act, the new guidelines bring clarity to areas of confusion in defining what are effective management practices for assessing internal controls for all agencies. This will ensure uniformity throughout agencies as they seek to establish an internal control structure that adequately meets appropriate levels of risk and program complexity.

In addition, the changes spell out requirements for agencies to report on and address deficiencies in their internal control structure. This is an improvement over previous practices, and will allow OMB to require an external opinion on agency internal controls when warranted. Our committee is well familiar with this practice, thanks to legislation enacted last session that was authored by the chairman of the subcommittee, my good friend, Congressman Platts from Pennsylvania, which required an independent review for internal control practices at the Department of Homeland Security.

With many agencies now in the process of implementing new financial management systems, I believe these requirements are timely and necessary. As I have said before, our failure to adequately implement appropriate business practices will have an adverse impact on operations for programs that so many of my constituents depend on for their well-being. Hopefully, the aforementioned changes will ensure that all of our agency programs will be efficient and effective.

Thanks again, Mr. Chairman, for holding this hearing, and on that note, I yield back.

Mr. PLATTS. Thank you, Mr. Towns.

We will proceed to our testimonies. If we could ask all of our witnesses to stand and take the oath. Any individuals who will be advising you as part of your testimony today should also stand and raise their right hand as well.

[Witnesses sworn.]

Mr. PLATTS. Thank you. Please be seated. The clerk will note that all witnesses affirmed the oath. Again, we appreciate the written testimony you have submitted. As I say to my kids, it is my homework that I bring home with me in my daily commute, and it allows me to be better prepared for our good dialog here today.

With your oral testimonies here today, if we can try to stay roughly in that 8 minute range in summarizing your written statements as best you see fit to do, then we will get into questions. Secretary Wolff, we are going to begin with you, please.

STATEMENTS OF OTTO J. WOLFF, CHIEF FINANCIAL OFFICER AND ASSISTANT SECRETARY FOR ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE; CHRISTOPHER B. BURNHAM, ACTING UNDER SECRETARY FOR MANAGEMENT, ASSISTANT SECRETARY FOR RESOURCE MANAGEMENT AND CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF STATE; JOHN P. HIGGINS, JR., INSPECTOR GENERAL, U.S. DEPARTMENT OF EDUCATION; AND JEFFREY C. STEINHOFF, MANAGING DIRECTOR OF FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

STATEMENT OF OTTO J. WOLFF

Mr. WOLFF. Mr. Chairman, Mr. Towns, thank you for the opportunity to appear before you today to discuss how my colleagues in the Federal financial management and audit communities have come together in concert with the Office of Management and Budget to strengthen the internal control requirements over financial reporting within the Federal Government.

As a result of our efforts, we have substantially improved the accountability and oversight of internal controls in all the Federal departments and agencies. These changes were the result of the administration taking a proactive and collaborative approach to improving financial management in the Federal Government and a direct result of President Bush's insistence on accountability at all levels of this administration. They are embodied in the revised OMB Circular A–123, Management's Responsibility for Internal Controls, which was signed in December by OMB Director Bolten. The revised circular will help managers assure proper controls are in place, documented and tested.

These changes will also strengthen the existing internal control assessment process in a cost effective manner. Additionally, these improvements will further support the goals of the President's management agenda by promoting a foundation of good controls from which timely and reliable financial information can be developed.

We are all too aware of highly publicized corporate failures and accounting scandals in recent years which reveal the lack of accountability and proper controls over financial reporting in publicly held companies, prompting the passage of the Sarbanes-Oxley Act of 2002. This legislation included for the first time ever the requirement that publicly held firms undertake significant efforts to provide assurance on the effectiveness of their financial reporting processes and to obtain audit opinion on internal controls, in addition to the traditional financial statement audits.

With the passage of Sarbanes-Oxley and the Department of Homeland Security Financial Accountability Act of 2004, the executive branch took the opportunity of reexamining our A–123 requirements. Linda Springer, back in November 2003, initiated a joint committee of both the CFOs and the IG community, the PCIE, to survey Federal agencies and identify differences in how current requirements are being implemented, to review requirements of publicly traded companies as laid out by Sarbanes-Oxley and to report on how these requirements may or may not apply to the Federal Government. The joint committee first examined the fundamental

differences between the public and private sectors. Federal entities operate in environments steeped in regulation, policies and procedures intended to ensure that all fiscal and budgetary actions are legal and comply with regulation and standard accounting practice.

Because the goals and motivation of Federal entities differ fundamentally from our private sector counterparts, they are much less vulnerable to the risk of manipulation of financial reporting to achieve personal gain. Also, the actions of Federal entities are open to public scrutiny and subject to multiple levels of oversight by the Congress, OMB, the Government Accountability Office and the independent inspectors general.

Unlike the private sector, the actions of the Federal entities are subject to a myriad of laws and regulations designed specifically to promote prudence and accountability. The list is long, the FMFIA, the FISMA, the Inspector General Act, the Chief Financial Officers Act, the Government Management Reform Act, the FFMIA, Improper Payments Act and others.

At the center of these requirements is the FMFIA, which establishes the overall internal control requirements. The act encompasses controls and programs, operational and administrative areas and accounting and financial management. It also requires the agency head to evaluate and report on the controls and financial systems that protect the integrity of Federal programs.

The joint committee reviewed the existing internal control requirements in A–123, and recommended OMB strengthen its guidance for assessing the effectiveness of internal controls. We developed a revised A–123, which would adopt the standards of the internal controls commonly used by private sector and developed by the COSO and published in its document. These standards were adopted previously by the GAO in its Green Book. Key points of definition of the financial audit were included in its amendments. As you can see, we did not reinvent the wheel amending A–123, we adopted private sector standards that were tailored to be more specific and responsive to the Federal environment.

The most significant change to Circular A–123 is the requirement for agency management to follow a more comprehensive and coordinated approach when assessing the effectiveness of internal control over financial reporting, and to document its assessment. Management must identify tests of documents and internal control effectiveness. A–123 defines the scope of reporting to include financial statements, significant other financial reports and compliance with laws and regulations that pertain to financial reporting.

The outcome of the assessment process requires a separate assurance statement from management to be included in the agency's performance and accountability report on the effectiveness of internal controls and financial reporting. The circular also provides for OMB to require an agency to have an internal control opinion level audit if that agency fails to meet expectations regarding correction of its internal control deficiencies.

The CFO Council plans to develop an implementation guide for A–123 which will complement the policy document and provide a more hands-on approach to the assessment of internal controls. And we will be sponsoring training for our Federal agencies to meet the new requirements.

In addition, the internal control improvements are being tracked through the quarterly scorecard process for improved financial performance initiative of the President's management agenda. This initiative emphasizes the need for effective internal control and getting to a green score on the score card requires that agencies eliminate all material control weaknesses. Ultimately, the goal is to assure managers are making more timely and informed decisions on operations and costs at both program and agency levels.

Yet this objective cannot be achieved without a foundation of effective internal controls from which financial information can routinely be generated and used for management decisions. I am pleased to report that Commerce just attained green status for improved financial performance in the first quarter of the current fiscal year. We are proud of our success and that of our seven other sister agencies who have also achieved green status.

The efforts involved at Cabinet level agencies to overcome obstacles to obtain clean audit opinions, to integrate financial management systems, and to eliminate material weaknesses cannot be overstated. With a higher bar now set by A–123 we realize that the implementation will require a serious and focused effort.

As part of the joint committee's review, agencies were polled to better understand the costs associated with conducting internal control assessments and audits. Unfortunately, the majority of agencies did not have sufficient experience with the process envisioned in the revised A–123 to be able to estimate the costs with any degree of certainty. Other agencies who have been performing the internal controls work for so long lacked solid data on costs because it is hard to identify separately. We will continue to work with the agencies to identify more specific cost data and we will let you know.

In closing, I would like to acknowledge the excellent collaboration and support in addressing this issue on the part of the PCIE, OMB and the whole CFO community. We received helpful suggestions as well, sir, from your committee staff and the GAO in our discussions with them. The approach presented here should be a model for how we can work together to ensure that Federal programs operate effectively and efficiently as possible. It is incumbent upon all of us to keep the Federal financial community focused on its stewardship responsibility.

Thank you again, Mr. Chairman, for the opportunity to appear before you today. I would of course be happy to answer any questions you may have.

[The prepared statement of Mr. Wolff follows:]

Testimony of
The Honorable Otto Wolff
Chief Financial Officer, Department of Commerce
Before the
Subcommittee on Government Management, Finance and Accountability
Committee on Government Reform
United States House of Representatives

February 16, 2005

The Effectiveness of Internal Control

Thank you, Mr. Chairman and members of the Subcommittee.

I am pleased to appear before you today to discuss how my colleagues in the federal financial management and audit communities have come together in concert with the Office of Management and Budget (OMB) to strengthen the internal control requirements over financial reporting within the Federal Government. As a result of this effort, we have substantially improved the accountability and oversight of internal controls of federal departments and agencies.

These changes were the result of the Administration taking a proactive and collaborative approach to improving financial management in the federal government. They are embodied in the revised OMB Circular A-123: *Management's Responsibility for Internal Control* (A-123), which was signed in December by OMB Director Bolten. The revised Circular A-123 will help federal managers ensure proper controls are in place, documented, and tested. These changes will also strengthen the existing internal control assessment process, in a cost-effective manner. Additionally, these improvements will further support the goals of the President's Management Agenda by promoting a foundation of good controls from which timely and reliable financial information can be developed.

Collaborative and Coordinated Approach

As we are all too aware, highly publicized corporate failures and accounting scandals in recent years revealed a lack of accountability and proper controls over financial reporting publicly-held companies, prompting the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act). This legislation included the first ever requirement that publicly-held firms undertake significant efforts to provide assurance on the effectiveness of their financial reporting process, as well as obtain an audit opinion on internal control in addition to the traditional financial statement audit. With the passage of the Sarbanes-Oxley Act and the Department of Homeland Security Financial Accountability Act of 2004, the Executive Branch took the opportunity to re-examine the internal control requirements within the Federal Government.

In November 2003, former OMB Controller Linda Springer initiated a joint committee of the Chief Financial Officers' Council (CFOC) and the President's Committee on Integrity and Efficiency (PCIE). This joint committee was tasked with surveying federal agencies to identify differences in how current requirements are being implemented, reviewing the requirements of publicly-traded companies as laid out in the Sarbanes-Oxley Act, and reporting how those requirements may, or may not, apply to the Federal Government.

The joint committee first examined the fundamental differences between the public and private sectors. Federal entities operate in an environment steeped in regulations, policies, and procedures intended to ensure that all fiscal and budgetary actions are legal. Because the goals and motivation of federal entities differ fundamentally from the private sector, they are much less vulnerable to the risk of manipulating financial reporting to achieve personal gain. Also, the actions of federal entities are open to public scrutiny and subject to multiple levels of oversight, including Congress, OMB, the Government Accountability Office, (GAO), and independent Inspectors General (IG).

Unlike the private sector, the actions of federal entities are subject to a myriad of laws and regulations designed to promote prudence and accountability. Examples of legislative requirements that support effective internal control include:

- the Federal Managers' Financial Integrity Act (FMFIA);
- the Federal Information Security Management Act (FISMA);
- the Inspector General Act;
- the Chief Financial Officers Act;
- the Government Management Reform Act;
- the Federal Financial Management Improvement Act; and
- the Improper Payments Information Act.

At the center of these requirements is the FMFIA which establishes overall internal control requirements. This Act encompasses controls in programs, operational and administrative areas, as well as accounting and financial management. It also requires the agency head to evaluate and report on the controls and financial systems that protect the integrity of federal programs.

Other regulatory requirements also exist to support effective internal control. For example, OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, requires auditors of federal financial statements to test and report on agencies' internal controls over financial reporting in connection with the audit of the financial statements. Auditors must report internal control material weaknesses and reportable conditions as part of the annual financial audit process. These auditor-identified material weaknesses are reported annually to the President and Congress in each agency's Performance and Accountability Report (PAR).

After the joint CFOC/PCIE committee reviewed the existing federal internal control requirements in OMB Circular A-123. It then recommended that OMB strengthen this guidance for assessing the effectiveness of internal control. The committee developed amendments to Circular A-123 that would adopt the standards of internal control commonly

used by the private sector and developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and published in its *Internal Control – Integrated Framework* document. These standards were adopted previously by the GAO in its *Standards for Internal Control in the Federal Government* (commonly known as the GAO Green Book). Key points and definitions from the GAO/PCIE Financial Audit Manual were also included in the amendments. As you see, we did not reinvent the wheel in amending A-123, we adopted private-sector standards that were tailored to be more specific and more responsive to the government environment.

Revised OMB Circular A-123

The most significant change to Circular A-123 is the requirement for agency management to follow a more comprehensive and coordinated approach when assessing the effectiveness of internal control over financial reporting and to document its assessment. Management must identify, test and document internal control effectiveness over financial reporting. Circular A-123 defines the scope of financial reporting to include financial statements, significant other financial reports and compliance with the laws and regulations that pertain to financial reporting. The outcome of the assessment process is a new separate assurance statement from management to be included in agency PARs on the effectiveness of the internal control over financial reporting.

Circular A-123 also includes a provision to permit OMB to require a separate audit of internal control under certain circumstances. Thus, if an agency fails to meet its deadlines outlined in its corrective action plan to resolve material weaknesses, OMB may direct a separate audit of internal control to better focus management's internal control improvement plans. This approach is a cost-effective way to implement a separate audit requirement.

The amendments to Circular A-123 are effective beginning in FY 2006. This fiscal year, federal agencies will be taking steps to prepare for its implementation. Here at Commerce, we have already begun to develop a plan that will identify the financial reporting scope, risk factors to assess, materiality levels, key controls, documentation requirements, and testing strategy. We will work in consultation with our Office of Inspector General to ensure effective implementation. The actual testing of controls is scheduled to begin in the second quarter of fiscal year 2006. We will then be in position to prepare our first management assurance statement for internal control over financial reporting as of June 30, 2006, to be included in our Performance and Accountability Report due November 2006.

In addition, the CFO Council plans to develop an implementation guide for A-123, which will complement the policy document and provide a more hands-on approach to the assessment process of internal controls over financial reporting. The CFO Council will also sponsor training to assist federal agencies in meeting the new requirements.

Related Initiatives

In addition to the separate assurance statement in agency PARs, internal control improvements are also being tracked through the quarterly scorecard process of the Improved

Financial Performance initiative of the President's Management Agenda (PMA). The Improved Financial Performance initiative emphasizes the need for effective internal control, and getting to a "green" score on the scorecard requires agencies to eliminate all material internal control weaknesses. Ultimately, the goal is to ensure managers are making more timely and informed decisions on operations and costs at both the program and agency-wide levels. Yet, this objective cannot be achieved without a foundation of effective internal control from which reliable financial information can be routinely generated and used to support management decisions.

I am pleased to report that Commerce recently attained "green" status in the Improved Financial Performance PMA initiative in the first quarter of fiscal year 2005. We are proud of our success, and that of the seven other CFO Act agencies that have also achieved that status. The efforts involved at a cabinet-level agency to overcome obstacles to obtain a clean audit opinion, integrate financial management systems, and eliminate material weaknesses cannot be overstated. With a higher bar now set out by Circular A-123, we realize that its implementation will require a serious and focused effort.

It should also be noted that the accelerated federal financial reporting requirement has also served as a significant motivating factor for improved internal controls. Agencies have had to strengthen their controls over financial reporting in order to meet the current accelerated due dates for financial statement preparation and audit from five months after the end of the fiscal year (as it was only a few years ago) to 45 **days** after the fiscal year (as it was for FY 2004). Because they are no longer able to rely on workarounds, or "compensating controls," agency CFO teams have invested additional resources in CFO operations and have reviewed their accounting systems and processes from a fresh perspective in preparing to meet the accelerated reporting requirement. New approaches to compiling accounting information, closing the books, and assembling financial statements and PARs have been implemented in order to meet the aggressive deadlines.

Cost Analysis

As part of the joint committee's review, agencies were polled to better understand the costs associated with conducting internal control assessments and audits. Unfortunately, the majority of agencies did not have sufficient experience with the process envisioned in Circular A-123 to be able to estimate the costs with any degree of certainty. Other agencies have been performing the internal controls work for so long that solid data on costs is likewise hard to separately identify. We will continue to work with agencies to identify more specific cost data. Likewise, additional cost data should soon be available from the private sector relating to implementing the Sarbanes-Oxley Act requirements.

Conclusion

In closing, I would like to acknowledge the excellent collaboration and support in addressing this issue on the part of the PCIE and OMB, working with the CFO community. In addition, we received helpful suggestions from your subcommittee staff and GAO in our discussions with them. The approach presented here should be a model for how we can work together to

ensure that federal programs operate as effectively and efficiently as possible. It is incumbent on us all to keep the federal financial community focused on this stewardship responsibility.

Mr. Chairman, thank you again for this opportunity to speak to you today. I would be happy to entertain any questions you or the members of the subcommittee may have.

Mr. PLATTS. Thank you, Secretary Wolff.

Secretary Burnham.

STATEMENT OF CHRISTOPHER B. BURNHAM

Mr. BURNHAM. Mr. Chairman, thank you very much, Mr. Towns. It's called editing on the go here, so we don't repeat too much.

I would request on behalf of all of us that our full written statements might appear in the record, Mr. Chairman.

Mr. PLATTS. Without objection.

Mr. BURNHAM. Thank you.

It is a great honor and opportunity to be here. This is a terribly important event. Although it is not always looked upon as the sexiest thing within our agencies, particularly at the State Department, nevertheless it is a terribly important aspect of how we run and conduct ourselves as stewards of the public trust.

I am here today not only as Chief Financial Officer of the State Department, but also as a member of the CFO Council. The CFO Council and Department of State fully support the revisions to Circular A–123. We commend this subcommittee for its efforts to promote and strengthen internal controls.

Sarbanes-Oxley was a necessary reaction to the heinous abuses of certain members of the corporate community and the need to restore broad investor confidence. No less important is the need to build taxpayer confidence in how their money is spent in Washington. The President's management agenda is the premier effort to accomplish this. Circular A–123 is and will be an essential part of that effort.

Under the direction of OMB in 2003 the CFO Council and the PCIE formed a joint committee, as my colleague Otto Wolff has said. The recommendations resulting from this joint effort formed the basis of the policy changes that we have seen today in A–123. The CFO Council also plans to work to develop an implementation and training guide, as my colleague also mentioned.

Mr. Chairman, I believe this Joint committee effort between the PCIE and the CFO Council is an excellent example of how both these communities, as well as the IG community, have worked together to advance the public good. We are grateful to our colleagues in the IG community for their professionalism and their dedication and their help in this effort.

For all Federal agencies implementing the revised Circular, it provides a valuable opportunity to reassess the effectiveness of our overall internal control structure. The level of effort required depends on, in large part, the degree to which an agency fully implements the previous version of Circular A–123, which was written in 1995. Today the implementation of FMFIA varies amongst Federal agencies. Some have rigorous FMFIA programs that allow their agency heads to provide unqualified annual assurances about their controls, while others do not. These mixed results will directly impact the level of effort and resources required to successfully implement the overall internal control requirements of the revised Circular across the Federal Government.

Some agencies, such as the State Department, will only need to modify slightly their existing management control programs. Others will need to overhaul their programs, particularly in the docu-

ment and management control area. It is too soon to reasonably determine the impact across the agencies of implementing Appendix A. Since the requirement of Appendix A is more rigorous and prescriptive than the preexisting requirements, it is uncertain how many agencies would meet the new requirement today.

Most agencies, including mine, will need to expand documentation and enhance assessments of internal controls over financial reporting. While we can and will learn from the private sector experience implementing Section 404 of Sarbanes-Oxley, it will take additional time to understand the impact of implementing Appendix A in the Federal agencies.

If I can, Mr. Chairman, let me just highlight a few things that State has done as an example of what you have in the executive branch and how we are dedicated to meeting these goals. Over the last 4 years, we are down from 10 weaknesses to zero. This gave the Secretary, in this case Secretary Powell 2 years ago, the first opportunity to issue a clean assurance statement.

The President's management agenda score card, something we all now live and perhaps die by, were double green, in both improved financial management as well as budget and performance integration. The President's quality award, the Malcolm Baldridge Award of Government, and I might also add, a fine Connecticut resident, the State Department won this year, one of seven agencies to win, recognizing our efforts to integrate the performance assessment rating to the PART system that OMB runs.

As many agencies did, we were able to meet the accelerated reporting timeframe that OMB mandated of November 15th. This has led to huge reforms within the CFO community and has helped us and will continue to help us not only to get to green but also to meet the particulars of Circular A–123.

We have a clean, timely financial opinion for the 8th year in a row, Mr. Chairman. And finally, our annual report, our performance and accountability report, has won the CEAR award, the Certificate of Excellence in Accountability Reporting for 4 years in a row. I might also add that compared with financial reports, annual reports in the private sector, 2 years ago we were fourth in the Nation, and this last year we were first in all of Government.

None of the successes would have been possible without a sound management control structure that permeates our entire organization. That starts from the top down. I met with Secretary Rice this morning. She emphasized again her support of this effort and the effort of what you're trying to lead, Mr. Chairman. We stand fully behind this effort and ready to implement in any way necessary, as I might add, does the CFO community.

With that sir, I will be happy to answer any questions from you or of the committee.

[The prepared statement of Mr. Burnham follows:]

Statement of The Honorable Christopher B. Burnham
Acting Under Secretary for Management,
Assistant Secretary for Resource Management
and
Chief Financial Officer
United States Department of State

Before the
Subcommittee on Government Management, Finance and Accountability
Committee on Government Reform
United States House of Representatives

February 16, 2005

"Changes to OMB Circular A-123,
***Management's Responsibility for Internal Control*"**

Thank you, Mr. Chairman, for the opportunity to appear before the Subcommittee today to discuss recent changes to the Office of Management and Budget's (OMB) Circular A-123, *Management's Responsibility for Internal Control.* I am providing my views on this subject from my perspective as both a member of the Chief Financial Officers' (CFO) Council and as the CFO of the United States Department of State. The CFO Council and Department of State fully support the revised Circular and commend this Subcommittee for its efforts to promote and strengthen internal control throughout the Federal Government in a thoughtful and progressive manner. We also applaud the work of the Office of Management and Budget (OMB) and the President's Council on Integrity and Efficiency (PCIE) to recognize and build upon the existing Federal internal control framework in an effort to strengthen and improve such controls through the revised Circular A-123.

Some of the nation's most dramatic business failures – notably Enron and WorldCom -- occurred in the early 2000's. These failures resulted in the passage of the Sarbanes-Oxley Act of 2002, which has led to sweeping changes in corporate accountability and the auditing profession.
In light of these developments and recent legislation requiring the Department of Homeland Security to adopt practices similar to those

imposed under the Sarbanes-Oxley Act, a reassessment of the existing internal control requirements for Federal agencies was begun in 2003. Fortunately, we have a solid foundation for internal control in the Federal Government resulting principally from the implementation of the Federal Managers' Financial Integrity Act (FMFIA) over the past two decades. It is against this contextual backdrop that the recent revisions to OMB Circular A-123 were developed.

Revisions to OMB Circular A-123

The Federal Government often lags behind the private sector in many areas but not when it comes to internal control. In large part due to FMFIA, the Federal Government has been required for more than two decades to establish and maintain an internal control structure that not only covers financial reporting but also spans across the full range of a Federal agency's programs and activities. FMFIA also requires that the head of the agency, based on an evaluation, provide an annual statement of assurance to the President and Congress on whether the agency has met this requirement.

Background

OMB Circular A-123 was first issued in the 1980's to provide guidance to Executive departments and agencies on implementing the FMFIA. Several revisions have been made to the Circular since the early 1980's to reflect the evolving nature and our improved understanding of internal controls during this time period. In the last two decades, much has been learned about the critical role internal controls play in organizations of any size.

Since the early 1980's, certain basic internal control tenets have evolved. What's clear now is that *every* entity – regardless of its purpose, size, form of ownership, or organizational structure – must have effective internal controls to carry out its mission. The responsibility for establishing and maintaining those controls rests squarely on the shoulders of management. To advance a common understanding of internal control, a conceptual framework, consistent definitions and terminology, and criteria for evaluating controls is needed to focus the efforts of internal control stakeholders such as entity managers, auditors, legislators, regulators, citizens, and academics. Internal control must be established, documented, evaluated, and monitored in every entity.

The Commission of Sponsoring Organizations of the Treadway Commission (COSO) is a leader in researching, developing, and promoting sound internal controls. COSO is an independent private sector initiative that studies the causes of fraudulent financial reporting and provides recommendations for preventing such occurrences by improving business ethics, internal controls, and corporate governance. In 1992, COSO published an integrated framework for internal control that is widely accepted and adopted throughout the private and public sectors today. This framework provides a conceptually sound and practical approach to establishing and evaluating internal controls.

Joint CFO Council and PCIE Efforts

Under the direction of OMB, in 2003 the CFO Council and PCIE formed a joint committee to evaluate the adequacy of internal control requirements in the Federal Government. This joint committee, comprised of representatives from the CFO and Inspector General (IG) communities, was tasked with reviewing the new internal control assurance requirements applicable to the private sector for their relevance to Federal agencies and developing new policies for internal control in the Federal Government, as considered necessary. The recommendations resulting from the joint committee's work formed the basis for the policy changes imbedded in the revised Circular A-123. The CFO Council also plans to work with OMB to develop an implementation guide and training for Federal agencies.

Mr. Chairman, I believe that this joint committee is an excellent example of how the CFO and IG communities can work together in a collaborative, professional manner to advance the public good. This model has been used successfully to facilitate the implementation of other important initiatives such as the Improper Payments Information Act of 2002. We are grateful to our colleagues in the IG community for the professional competence, technical skills, and business acumen they bring to bear on assessing internal control policies in the Federal environment. We look forward to working with them as we address the many challenges ahead.

Key Provisions of the Revised Circular A-123

The revised Circular reaffirms management's responsibility for internal control in Federal programs and operations, and provides explicit guidance for management to use in carrying out its charge to establish, assess,

strengthen, and report on internal control. The revised Circular calls for Federal agencies to deploy systematic and proactive measures to:

- Develop and implement appropriate, cost-effective internal control for results-oriented management;
- Assess the adequacy of internal control in Federal programs and operations;
- Separately assess and document internal control over financial reporting;
- Identify needed improvements;
- Take corresponding corrective action; and
- Report annually on internal control through management assurance statements included in the PAR.

The revised Circular builds off of the fundamental principles underlying its predecessor (i.e., Circular A-123, revised June 21, 1995) to advance internal control to a new level within the Federal Government. In addition to providing more comprehensive and detailed internal control guidance to Federal managers, the revised Circular also includes the following significant changes.

- **Strengthens the Requirements for Assessing the Effectiveness of Internal Control over Financial Reporting** – This area is viewed by many in the Federal financial management community as the most significant change imposed by the revised Circular. Appendix A of the Circular provides new specific requirements for conducting and documenting management's assessment of the effectiveness of internal control over financial reporting, including a separate annual assurance on internal control over financial reporting. These new requirements are similar to those imposed by the Sarbanes-Oxley Act for the management of publicly-traded entities to assess, document, and report on the effectiveness of internal control over financial reporting.

- **Integrates Agency Internal Control Activities** – The revised Circular emphasizes the need for agencies to consider, coordinate, and integrate other internal activities – many of which are required by statute -- that contribute to internal control. For instance, the Improper Payments Information Act of 2002 requires agencies to determine which Federal programs are susceptible to improper payments, test high-risk programs, report the results in agency PARs, and determine the underlying cause for

improper payments. This process will contribute to and strengthen an agency's internal control infrastructure. The revised Circular A-123 serves as the internal control umbrella under which other agency activities should be integrated to support management's assertion about the effectiveness of internal control more broadly.

- **Incorporates COSO Framework** – The revised Circular reflects currently accepted standards, objectives, and terminology for internal control based on the COSO framework and its five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.

- **Encourages Use of Senior Management Councils and Senior Assessment Teams** – The Circular recognizes the important role of senior management councils in Federal agencies to oversee the internal control program throughout the entity. The Circular also recommends the use of senior assessment teams, as a subset of the senior management council, to drive management's assessment of internal control over financial reporting.

- **Creates Reportable Condition Category under FMFIA** – The revised Circular defines control deficiencies and introduces the concept of reportable conditions under FMFIA reporting. This category is important because it must be tracked and monitored internally, which will help to resolve reportable conditions before they become material weaknesses.

- **Authorizes OMB to Require an Audit Opinion Selectively** – While a separate audit opinion on internal control over financial reporting is not required by the Circular, OMB may, at its discretion, require an agency to obtain such an opinion. This provision would be used in situations where an agency continuously falls behind in correcting its deficiencies.

- **Requires Service Organizations to Provide Assurances** -- The revised Circular calls for management of cross-servicing agencies to provide an annual assurance statement, based on testing, to their customer agencies.

The CFO Council fully supports the changes to Circular A-123. Each of the significant changes makes sense in the Federal environment and should lead

to greater accountability for Federal programs and operations, including financial reporting.

Impact of Revised Circular on Federal Financial Management

Internal control is central to fulfilling our responsibility for accountability over taxpayer funds. We have recently witnessed in the private sector the catastrophic results that failures in internal control can trigger. Unfortunately, internal control is far from the most exciting subject to debate, and it usually takes a high-profile breakdown in controls for people to even notice them. Also, because internal controls focus on prevention, it is often very difficult to quantify the impact of improved controls. For instance, how do you measure the impact of fraud that was prevented, or the increase in public confidence that results from stronger control?

Despite these difficulties, the current increased attention on internal control is well-placed. After two decades of implementing FMFIA, we understand what our counterparts in the private sector now appreciate – that internal control is integral to every part of an organization's infrastructure rather than an isolated management tool. In the end, stronger controls yield beneficial dividends – even though they are difficult to measure.

For all Federal agencies, implementing the revised Circular provides a valuable opportunity to reassess the effectiveness of their overall internal control structure. The level of effort required depends in large part on the degree to which an agency fully implemented the previous version of Circular A-123, dated June 21, 1995. Today, the implementation of FMFIA varies among Federal agencies – some have rigorous FMFIA programs that allow their agency heads to provide "unqualified" annual assurances about their controls while others do not. These mixed results, will directly impact the level of effort and resources required to successfully implement the overall internal control requirements of the revised Circular across Federal agencies. Some agencies such as the State Department will only need to modify slightly their existing management control programs. Others may need to overhaul and document their management controls. It is interesting to note that with respect to an entity's overall internal control structure (formerly known as "management controls"), the Federal Government's pre-existing requirement for annual assurance statements by agency heads exceeds management's requirements for publicly-traded companies under the Sarbanes-Oxley Act.

It is too soon to reasonably determine the impact across agencies of implementing Appendix A of the revised Circular, which imposes new specific requirements for conducting management's assessment of the effectiveness of internal control over financial reporting. Arguably, Federal agencies should have been documenting and assessing internal controls over financial reporting as part of FMFIA. However, since the requirements of Appendix A are more rigorous and prescriptive than the pre-existing requirements, it is unlikely that many Federal agencies would meet these new requirements today. Most agencies will need to expand documentation and enhance assessments of internal control over financial reporting. While we can and will learn from the private sector experience implementing similar requirements under the Sarbanes-Oxley Act, it will take additional time to understand the incremental impact of implementing Appendix A in Federal agencies.

Importance of Controls at Department of State

At the Department of State, we take our statutory responsibility under FMFIA very seriously. We have developed a robust management control structure that has been recognized as a best practice by OMB and enabled the Secretary of State to provide an unqualified (or "clean") assurance statement for 2003 and 2004. As a result, we are now well-positioned to implement the revised Circular A-123 – not just the letter of the revised Circular but also the spirit and intent of this Administration to strengthen stewardship over taxpayer funds that underpin the revised Circular.

A strong management control structure is essential for an organization such as the State Department, which functions in an extremely challenging and complex environment. The Department operates about 260 embassies and consulates located in more than 170 countries throughout the world as well as our domestic operations. We conduct business transactions in over 150 currencies and even more languages and cultures. We provide the administrative operating platform for about 45 other U.S. Government organizations overseas and pay 64,000 persons each pay period on behalf of the Department and other serviced agencies. In short, no corporation or other Federal agency has the depth and variety of challenges faced daily by our team in support of the Department's mission to create a more secure, democratic, and prosperous world for the benefit of the American people and international community.

While we have a proud tradition of embracing both the concepts and practical application of controls throughout the State Department, we welcome the opportunity to strengthen them further as called for under the revised Circular. We recognize that robust controls are essential to managing our day-to-day activities and programs and they position us to face with confidence the many challenges that lay ahead as we carry out the Department's foreign policy mission.

Strong Controls Contribute to Our Success

The Department's management control program provides a solid foundation for moving beyond mere compliance with laws and regulations towards achieving world-class excellence in managing Federal programs and operations. Our sustained focus over the years on strengthening management control has served as a catalyst for positive change within the Department, resulting in the reduction of FMFIA material weaknesses from 10 in FY 1999 to zero by the end of FY 2002. In addition, for the first time in 2003, and again in 2004, the Department's independent auditors reported no material weaknesses in internal control. Our rigorous management control program has also led the way for the following significant accomplishments:

- **President's Management Agenda Scorecard** – In January 2005, OMB identified State, along with three other Federal agencies (Energy, Labor, and the Social Security Administration), as the most successful at implementing the management disciplines that underpin the *President's Management Agenda (PMA).* The Department has "double greens" for status and progress in implementing the PMA in the following areas: human capital, financial performance, E-Gov, and budget and performance integration.
- **President's Quality Award** – In December 2004, the Department received the President's Quality Award for its innovation in integrating OMB's Program Assessment Rating Tool (PART) into the Department's overall strategic and performance management processes, and for having some of the highest PART scores government-wide. This prestigious award is the highest recognition given by the Federal Government for managerial excellence.

- **Accelerated Reporting** – We completed our 2004 Performance and Accountability Report (PAR) by November 15, 2004 – a feat unimaginable just a few years ago. When I joined the Department in 2002, it took about five months after year-end to complete the annual financial statement audit, as compared to just 45 days for FY 2004. Meeting this goal for the first time in 2004 is particularly noteworthy in light of our competing priorities to support our mission in Iraq and successfully relocate our global financial operations to Charleston, SC.

- **Financial Accountability** – For the eighth consecutive year, we received an unqualified (or "clean") audit opinion on the Department's 2004 financial statements, which was especially challenging under the accelerated reporting date of November 15. Only a handful of Federal agencies can tout such a long-running accomplishment.

- **Award-Winning Reports** -- For the third year in a row, the Department's FY 2003 PAR received the most prestigious award in Federal financial reporting, AGA's *Certificate of Excellence in Accountability Reporting*. State is one of only four cabinet-level agencies to receive this award for FY 2003. Also, for the second year, the League of American Communications Professionals selected the Department's 2003 *PAR Highlights* report as one of the best 100 annual reports in America and placed it first among government reports.

None of these successes would have been possible without a sound management control structure that permeates our organization – from the tone set by top management to the manner in which transactions are processed on a daily basis, and every step in between.

Our Current Control Program: ***A Best Practice***

Each year under FMFIA, the Department evaluates its management control systems. These evaluations provide reasonable assurance about whether the objectives of FMFIA are achieved and form the basis for the Secretary's annual statement of assurance. Exhibit 1 depicts our current FMFIA annual assurance process.

The Department's management control program is overseen by the Management Control Steering Committee (MCSC), which I chair as the Assistant Secretary for Resource Management and Chief Financial Officer.

The MCSC also includes nine other Assistant Secretaries [including the Chief Information Officer and the Inspector General (non-voting)], the Deputy Chief Financial Officer, and the Deputy Legal Adviser. State's Office of Inspector General has served an important role as a collaborative partner with management through the MCSC, and adds value to the entire process.

Individual assurance statements from Ambassadors assigned overseas and Assistant Secretaries in Washington, D.C. serve as the primary basis for the Department's assurance that management controls are adequate. Individual assurance statements are based on information gathered from various sources including the managers' personal knowledge of day-to-day operations and existing controls, management program reviews, and other management-initiated evaluations. In addition, the Office of Inspector General and the Government Accountability Office conduct periodic reviews, audits, inspections, and investigations of the Department's programs and activities.

To be considered a material weakness for FMFIA reporting purposes, the problem should be significant enough that it meets one or more of the following criteria.

- Significantly impairs the fulfillment of the Department's mission.
- Deprives the public of needed services.
- Significantly weakens established safeguards against waste, loss, unauthorized use or misappropriation of funds, property, other assets, or conflicts of interest.
- Merits the attention of the Secretary, the President, or a relevant Congressional oversight committee.
- Is of a nature that omission from the report could reflect adversely on the Department's management integrity.

During the last five years, the Department made significant progress by correcting each of its outstanding material weaknesses. In addition, there are no items specific to the Department on the Government Accountability Office's High Risk List, and there have not been any since 1995. Exhibit 2 shows the Department's progress correcting and closing material weaknesses.

In fiscal year 2002, the Department added the category of "reportable condition" to our program, which is now included in the revised Circular. Reportable conditions are less significant control matters that do not need to be reported under FMFIA but warrant MCSC monitoring and internal tracking. By introducing the reportable condition category of control weakness, the Department moved beyond merely fixing material weaknesses to actively identifying and preventing them.

Implementing the Revised Circular: ***A "Green" Agency's Perspective***

Building off of our successful FMFIA program and in the spirit of continuous improvement, we look forward to fully implementing the revised Circular. This provides us with the opportunity to take a fresh look at the effectiveness of our overall internal control program in today's environment.

While we expect to identify and implement certain improvements to our overall program, we do not expect wholesale changes. For instance, we envision a broader and more active role for our Management Control Steering Committee, particularly as it relates to internal control over financial reporting and the consideration of fraud within the Department (relating to Statement on Auditing Standards 99, *Consideration of Fraud in a Financial Statement Audit*). The MCSC will also play a key role in integrating other activities within the Department that contribute to our internal control structure. As mentioned previously, we already identify and track reportable conditions through the MCSC, so implementing this aspect of the revised Circular will not cause us additional effort. We intend to fully adopt COSO's integrated framework for internal control, which will prompt revisions to our current FMFIA annual assurance process and related risk assessment tools. Of course, training would need to be provided at all levels of the Department to explain our enhanced internal control program and how each employee contributes to that program.

Most of the changes to our overall control program will be implemented by State Department employees in the normal course of performing their daily activities, though some contractor support is planned. We are currently trying to determine whether our existing documentation of management control processes meets the requirements of the revised Circular. For instance, a starting point for us is to determine whether the documents produced in connection with our efforts to adopt the International Organization of Standardization's ISO 9000 quality management standards

would meet the requirements of revised Circular. Should we discover documentation gaps, there will be resource implications.

The requirements of Appendix A present the most significant challenge to us. While we have extensive documentation of certain financial reporting processes and controls, we do not believe that the documentation is sufficiently comprehensive to fully satisfy the Circular's requirements. This is another area in which we are actively trying to determine the resource implications of fully implementing the revised Circular. As both a cross-servicing agency and a customer of other Federal service organizations, we are assessing the impact of the new requirement for service organizations to provide annual assurance statements, based on control testing, to their customers. We are using a contractor skilled in audit techniques to assist us in implementing the requirements of Appendix A.

We expect to incur one-time cost increases in 2005 and 2006 as we concentrate on first-time documentation and assessment efforts. We anticipate these costs dropping off and stabilizing for 2007 and beyond. It is too soon to quantify the impact of fully implementing the revised Circular. Once we comply with Appendix A, we expect our financial statement auditors to use management's work as a starting point for conducting the audit, which may yield some audit savings.

We view this revised Circular as an important means of appropriately managing the risk associated with Federal programs and activities to discharge our responsibilities as stewards of public funds. As a "green" agency, we will not rest on our accomplishments. As contemplated under the PMA Scorecard, we are continuously seeking to improve further our management of the State Department. The revised Circular provides us with the framework and tools needed to make significant advancements to our internal control infrastructure.

Conclusion

The CFO community appreciates the opportunity to implement the important policies included in the revised Circular A-123 in a systematic and orderly fashion. It is critical for management to understand, document, and assess its internal control over financial reporting to attain stewardship over taxpayer funds. We believe that the Circular, when fully implemented, will drive further improvements in the accuracy and timeliness of Federal

financial reporting. We also believe that the revised Circular will cause agencies, such as the State Department, to re-examine existing control programs to identify opportunities to strengthen controls over the entire portfolio of Federal programs and operations.

Thank you, Mr. Chairman, for allowing me to share my views on OMB's revised Circular A-123. My colleagues in the CFO Council and I appreciate your leadership and the Committee's on this and other Federal financial management initiatives. I look forward to answering any questions you may have.

Exhibit 1: State's FMFIA Annual Assurance Process

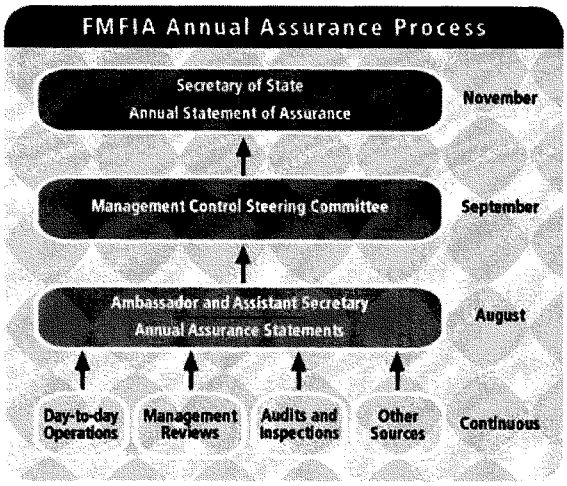

Exhibit 2: State's Material Weaknesses (FY 2000 through 2004)

MATERIAL WEAKNESSES BY FISCAL YEAR				
Fiscal Year	**Number at Beginning of Fiscal Year**	**Number Corrected**	**Number Added**	**Number Remaining at End of Fiscal Year**
1999	10	7	0	3
2000	3	2	2[1]	3
2001	3	0	0	3
2002	3	3	0	0
2003	0	0	0	0
2004	0	0	0	0

Note 1: Reported by State as a result of the merger with the United States Information Agency.

Drafted: RM/DCFO/FPRA:SConley
2/10/05; ext. 31447

Cleared:	D:EYoung	(ok)
	P:MWong	(ok)
	S/P:EGreen	(ok)
	M:SFeeley	(ok)
	M/P:DWertman	(ok)
	RM/DCFO:CFlaggs	(ok)
	RM/CFO:CScalzo	(ok)
	H:SEdmondson	(ok)

cc: RM/BP - Eric Hembree/Steve Dietz
RM/SPP - Sid Kaplan/Jason Foley

Mr. PLATTS. Thank you, Secretary Burnham.

Before we move on, I do want to recognize our vice chairwoman for the subcommittee, the gentlelady from North Carolina Ms. Foxx has joined us. Thanks for being with us.

Inspector General Higgins.

STATEMENT OF JOHN P. HIGGINS, JR., INSPECTOR GENERAL OF THE DEPARTMENT OF EDUCATION

Mr. HIGGINS. Mr. Chairman and members of the subcommittee, on behalf of the President's Council on Integrity and Efficiency, thank you for the opportunity to discuss our perspectives on the changes made to OMB Circular A–123, Management's Responsibility for Internal Control. I would also like to thank the committee for its dedication to the goal of improving financial management Government-wide, as well as its interest in legislation that would enhance the independence of the Inspectors General.

The Federal Managers Financial Integrity Act of 1982 and OMB's implementing guidance contained in A–123 defined management's responsibility for internal control in Federal agencies, and are the center of the existing Federal requirements to improve internal control. Other significant legislation passed since the passage of the Integrity Act continued to highlight the importance of efficient and effective internal controls.

My testimony will focus on four points: first, the importance of effective internal controls; second, how the audit community can coordinate its efforts with those of agency management; third, our perspectives on how the recent changes to A–123 may affect Federal financial management in general; and fourth, our views on future legislative action on Federal financial management.

Internal control is important because it is the first line of defense in safeguarding assets and preventing and detecting errors and fraud. Effective internal controls help ensure accountability for resources, achievement of organizational objectives and availability of improved information for external reporting and internal management decisions.

In short, internal control is a key factor in helping agencies achieve effective and efficient operations, reliable financial reporting and compliance with applicable laws and regulations. It is a fundamental and statutory responsibility of management to institute effective internal controls, assess them periodically and make course corrections as needed. Events of high profile fraud and mismanagement in the private sector and the Federal Government's own financial reporting problems have resulted in the increased focus on management's responsibility for internal control and dispelled the myth that internal control is but a mere academic exercise or it is of interest only to auditors and accountants.

We must realize, however, that having effective internal control is not a guarantee that agencies will achieve the objectives of internal control. Effective internal control is designed to provide reasonable, not absolute, assurance of achieving those objectives. Establishment of specific controls is subject to cost benefit considerations, availability of resources to implement the controls, and any limitations or restrictions imposed by legislation. Effective internal

controls also may be overridden by management and circumvented through collusion.

My second point is how the audit community and agency management coordinate on internal control issues. This occurs at both the agency and Government-wide levels. There is ongoing coordination between agencies and their OIGs that can be helpful to agencies as they work to implement new guidance. Coordination between the audit community and agency management on internal control matters is inherent in the OIG's mission. The resolution of audit fundings provides a primary avenue for OIGs and agency management to discuss control assessments and propose corrective actions.

At the Government-wide level, the type of cooperation that occurred between the CFO Council and the PCIE on the revisions to A–123 is not uncommon. The audit community, under the PCIE, periodically works with the CFO Council on internal control and management issues. An example is the joint CFO Council and PCIE Working Group on Improper Payments. This collaborative work group's mission is to facilitate the reduction of improper payments throughout the Federal Government.

These ongoing efforts to address internal control issues are a natural outgrowth of the responsibilities and relationships that OIGs have with their agencies. While the work of the OIGs can be helpful to agencies as management makes its own assessments, it cannot replace management's own assessment efforts, which is contemplated under the new guidance. In addition, the OIG must guard against consulting type arrangements that might impair our independence for performing future audits.

Third, I would like to turn our attention to major changes in A–123 and their potential impact on Federal financial management. In the past, the implementation of the Integrity Act has been inconsistent. The impact of the recent changes to A–123 depends on how aggressively an agency assessed its controls under the old guidance and how it will implement the new guidance.

The most significant change is the new requirement for management to assess and document internal control over financial reporting and to provide a corresponding assurance statement annually that asserts the effectiveness of internal control over financial reporting.

Another significant change is the more specific and strengthened requirement for management to have a clear, organized strategy with well-defined documentation processes that contain an audit trail, verifiable results, and specify document retention periods. This would enable someone not connected with the procedures to understand the assessment process. The documentation standard pertains to all internal control assessments management performs, not just those related to controls over financial reporting.

Another significant change is OMB's inclusion of the provision requiring an opinion on internal controls over financial reporting, if an agency continually misses agreed upon deadlines for correcting material weaknesses. This was a prudent, cost-effective way to provide flexibility to address serious, longstanding problems without forcing a one size fits all approach Government-wide.

In the end, the effectiveness of the Integrity Act depends on management's commitment to the intent of the legislation and implementing guidance. If aggressively implemented in a cost-effective manner, the resulting improvements to internal control should assist Government program managers in achieving desired results through effective stewardship of public resources.

Finally, let me turn to my fourth point on future legislative action. Effective internal controls and financial management are core concerns of the PCIE community. We appreciate the opportunity to communicate with you and the CFO Council on these issues today. As your subcommittee moves forward to consolidate laws affecting these areas, we in the IG community welcome the opportunity to continue the dialog and provide assistance. The reassessment of financial management requirements of Federal agencies should be conducted in a cautious and deliberate manner, carefully considering the costs and the anticipated benefits of the changes.

This concludes my statement, and I would be happy to answer any questions.

[The prepared statement of Mr. Higgins follows:]

Statement of John P. Higgins, Jr.
Inspector General of the Department of Education
and
Chair of the Audit Committee
President's Council on Integrity and Efficiency

Before the
Subcommittee on Government Management, Finance and Accountability
Committee on Government Reform
United States House of Representatives

February 16, 2005

Mr. Chairman and Members of the Subcommittee:

On behalf of the President's Council on Integrity and Efficiency (PCIE), thank you for the opportunity to discuss our perspectives on the changes made to the Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control* (A-123). I would also like to thank the committee for its dedication to the goal of improving financial management government-wide.

The Federal Manager's Financial Integrity Act of 1982 (FMFIA) and OMB's implementing guidance contained in A-123 define management's responsibility for internal control in Federal agencies, and are the center of the existing Federal requirements to improve internal control. Other significant laws since passage of FMFIA continued to highlight the importance of efficient and effective internal controls to improving financial management and programmatic performance. Examples of such laws include the Chief Financial Officers Act of 1990, the Government Performance and Results Act of 1993, the Federal Financial Management Improvement Act of 1996, and the Clinger-Cohen Act, to name a few.

My testimony will focus on the importance of effective internal control, why A-123 was revised, how the audit community can coordinate its independent role with agency management's requirement to assess the effectiveness of internal control, our perspective on how the recent changes to A-123 may affect Federal financial management in general, and our views on future legislative action on Federal financial management.

I. Importance of Internal Control

Effective internal control is a key factor in helping agencies to achieve the following objectives:

- Effectiveness and efficiency of operations and programs;
- Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for external and internal decision-makers; and

- Compliance with applicable laws and regulations.

Internal control also serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud.

FMFIA required the Government Accountability Office (GAO) to issue standards for internal control in the Federal government. The latest version of the standards was issued in November 1999 and is based on the private sector internal control guidance known as *Internal Control — Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). GAO discusses the fundamental objectives identified above and establishes five standards of internal control that define the minimum level of quality acceptable for internal control in the Federal government and provide the basis against which internal control is to be evaluated. The five standards for internal control are:

- Control Environment,
- Risk Assessment,
- Control Activities,
- Information and Communications, and
- Monitoring.

It is a fundamental and statutory responsibility of management to institute effective controls, assess them periodically, and make course corrections as needed, to ensure accountability for resources and achievement of organizational objectives. Events of recent years have dispelled the myth that internal control is but a mere academic exercise or is of interest only to accountants or auditors. High profile fraud and mismanagement in the private sector, and the Federal government's own financial reporting problems, have resulted in an increased focus on management's responsibility for internal control.

My own office's audit and investigative efforts have shown weak or poorly executed internal controls to be at the heart of problems that led to poor management decisions, ineffective financial reporting, and outright theft and fraud. For example, in recent work, we have recommended that the Department of Education improve internal controls to ensure that the data used to identify the most at-risk schools is complete, accurate, and applicable to the schools being evaluated. Other work found a guaranty agency's claim review process for defaulted loans was not adequate to ensure that it claimed reinsurance only when appropriate.

Conversely, Education's success as one of the first cabinet level agencies to earn an unqualified or clean opinion on its financial statements by the accelerated date of November 15, 2003, one year ahead of the requirement, is due primarily to a sustained commitment by management to improving controls in the area of financial reporting. As these and future financial reporting improvements take hold across government, agencies should have better information for external reporting and internal management decisions.

As important as internal control is, I do want to point out that having effective internal control is not a guarantee that the previously mentioned objectives of internal control will be achieved. Effective internal control is designed to provide reasonable, not absolute, assurance of achieving those objectives. Also, the establishment of specific controls is subject to cost/benefit considerations, availability of resources, and any limitations or restrictions imposed by law. Effective internal controls also may be overridden by management and circumvented through collusion.

II. Why OMB Circular A-123 was Revised

The generally accepted importance of internal control, recent financial reporting problems in both the Federal government and private sector, and the resulting new internal control requirements for public companies under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), converged to lead OMB to convene a joint committee of the Chief Financial Officers Council (CFO Council) and PCIE to reassess internal control requirements in the Federal government. The new A-123 guidance resulted from that joint effort.

The joint committee considered that at the heart of Sarbanes-Oxley is the new requirement that management of publicly traded companies assess the effectiveness of internal control over financial reporting and that the independent auditors provide an opinion on those controls. While FMFIA and A-123 had already required Federal government management to make an assertion about controls, the committee concluded that the guidance should be revisited in light of Sarbanes-Oxley.

The result was an increased focus on management's assessment and improvement of internal control over financial reporting, more stringent documentation requirements for all of management's internal control assessment activities under FMFIA, and inclusion of a non-compliance clause that permits OMB to require an agency to obtain an audit opinion over the internal control over financial reporting if agreed upon deadlines for correcting material weaknesses are not met.

III. Coordination Between the Audit Community and Agency Management on Internal Control Issues

The type of cooperation that occurred between the CFO Council and PCIE on the revisions to A-123 is not uncommon. The Inspector General Act of 1978 (IG Act) has as one of its purposes "...to create independent and objective units...to provide leadership and coordination and recommend policies for activities designed (A) to promote economy, efficiency, and effectiveness in the administration of, and (B) to prevent and detect fraud and abuse in...programs and operations." There is an ongoing coordination between agencies and their OIGs that can be helpful to the agencies as they work to implement the new guidance. However, we must guard against consulting type arrangements that might impair our independence for performing future audits.

Coordination between the audit community and agency management on internal control matters is inherent in the OIG's mission. The continuing assessment of controls surrounding an agency's programmatic, financial and compliance efforts, and the subsequent public reporting of the results require this coordination. The requirements of A-123 are the responsibility of an agency's management and not its auditors. Therefore, while OIG work can be a useful supplement to management's own assessments of controls and plans for corrective actions, and can provide an independent validation of management's assessments, OIG work does not replace management's efforts.

The resolution of audit findings provides a primary avenue for OIGs and agency management to discuss control assessments and corrective actions. The audit resolution process, where the auditors and agency management reach agreement on corrective actions for reported OIG findings, is a fundamental part of the PCIE community's work. While the final decision about how to implement corrective actions is a management decision, there is still significant coordination and communication between the OIG and management on the course of action to be taken.

Another avenue for coordination on internal control issues is in the requirements of the Reports Consolidation Act of 2000. This act requires each IG to summarize what the IG considers to be the most serious management and performance challenges facing the agency and briefly assess the agency's progress in addressing those challenges. This is included in the agency's annual Performance and Accountability Report, along with the audited financial statements and auditor's reports.

My office currently has two special efforts underway with Education's management that address internal control issues. The first is a joint effort by my office and the Department of Education to develop a systematic process for identifying fraud types, both actual and potential, in the Student Financial Aid (SFA) programs. A second effort is an on-going campaign to alert students to the threat of identify theft by updating our website, www.ed.gov/misused, with information concerning recent scams against the SFA programs. This website was developed in conjunction with the Department's Office of Federal Student Aid (FSA).

At the government-wide level, the audit community under the PCIE periodically works with the CFO Council on internal control and management issues. An example is the Joint CFO Council and PCIE Working Group on Improper Payments. This collaborative Working Group's mission is to facilitate the reduction of improper payments throughout the Federal government. The Working Group researched improper payments, critiqued potential methods of identifying and quantifying improper payments, developed improper payment indicators, and established benchmarks for measuring and preventing improper payments. In addition, the Working Group developed a common format for reporting improper payment results in agencies' Performance and Accountability Reports.

These ongoing efforts to address internal control issues are a natural outgrowth of the responsibilities and relationships OIGs have with their agencies. The work of the OIGs,

while helpful to the agencies as they make their own assessments, cannot replace management's assessment efforts contemplated under the new guidance.

IV. Significant Changes to A-123 and the Impact on Federal Financial Management

I would like to turn our attention to the major changes to A-123 and their potential impact on Federal financial management.

Across the government, the implementation of FMFIA has been inconsistent. GAO reports for several years have noted agency FMFIA reporting that does not accurately characterize or fully disclose the weaknesses in their controls. And in some cases, agencies have settled into a pattern of reporting what the OIG or GAO may find, with little or no emphasis on management performing its own risk assessments and control testing. The impact on Federal financial management of the recent changes to A-123 depends on how aggressively an agency assessed its controls under the old guidance, and how it implements the new requirements.

The most significant change is the new requirement for management to assess and document internal control over financial reporting, and provide a corresponding assurance statement annually that asserts to the effectiveness of internal control over financial reporting as of June 30th. A separate appendix addressing this area was added to A-123 and provides specific requirements for conducting management's assessment of the effectiveness of internal control over financial reporting. This emphasizes that management, and not the financial statement auditor, is responsible for implementing and assessing controls over financial reporting. Having an annual assessment by management will help ensure that once an agency has effective internal control, it will not deteriorate over time as personnel change and financial systems are replaced or changed. This renewed emphasis is critical to ensuring that agencies have good financial management information for managing their operations and should assist the Federal government in eventually receiving an unqualified opinion on its financial statements.

Another significant change is the more specific and strengthened requirement for management to "have a clear, organized strategy with well-defined documentation processes that contain an audit trail, verifiable results, and specify document retention periods so that someone not connected with the procedures can understand the assessment process." This documentation standard pertains to all the internal control assessments management performs, not just those related to controls over financial reporting.

Updating the language and definitions in A-123 to align with the language in the COSO framework, the GAO internal control standards and the auditing literature should help eliminate confusion over what internal control really is, and promote a common understanding of materiality when assessing and reporting on internal control over financial reporting. It will be interesting to see if the new definition of reportable condition results in the reporting of more internal control deficiencies, which could provide the impetus for additional improvements in agencies' financial management.

We also agree with OMB's inclusion of the provision requiring an opinion on internal controls over financial reporting, if an agency continually misses agreed-upon deadlines for correcting material financial control weaknesses. This was a prudent, cost effective way to provide flexibility to address serious, longstanding problems, without forcing a one size fits all approach government-wide.

The argument could be made that in the government arena, FMFIA and A-123 requirements have been around for a long time and the incremental costs should not be significant. However, the two documentation requirements described above could have significant resource impacts on the agencies implementing them. Both requirements provide greater specificity regarding what an agency should document and retain in support of its assessment of internal control. Similar type changes in the private sector suggest that, if aggressively implemented, the A-123 requirements could have significant costs associated with them. For example, much has been written about the impact of implementing the Sarbanes-Oxley requirement for a management assertion on the effectiveness of internal control over financial reporting of public companies, including the costs of enabling management to make the required assessments and assertions. There has also been discussion about the impact on accountants and auditors as companies compete for a limited pool of resources to help them meet their new responsibilities, and on CPA firms as they pare back smaller clients and reassign staff to the large public companies that must address the new requirements. This gives us an indication of increased costs associated with implementing the required assessments in A-123.

In the end, the effectiveness of FMFIA depends on management's commitment to the intent of the law and implementing guidance. If aggressively implemented in a cost effective manner, the resulting improvements to internal control should assist government program managers in achieving desired results through effective stewardship of public resources.

V. Future Legislative Action on Federal Financial Management

Effective internal control and financial management are core concerns of the PCIE community, and we appreciate the opportunity to communicate with you on these issues today. As your subcommittee moves forward to address the patchwork of laws affecting these areas, we in the IG community welcome the opportunity to continue the dialogue and provide assistance. Our accumulated experience in reviewing Federal operations since passage of the Inspector General Act over 25 years ago could provide valuable insight for a reassessment of the existing financial management laws. Finally, the reassessment of financial management requirements of Federal agencies should be conducted in a cautious and deliberate manner, carefully considering the costs and anticipated benefits of any changes.

This concludes my statement. I would be happy to answer any questions you may have.

Mr. PLATTS. Thank you. Mr. Steinhoff.

STATEMENT OF JEFFREY C. STEINHOFF, MANAGING DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. STEINHOFF. Mr. Chairman, members of the subcommittee, I'm very pleased to be here today to talk about internal control and OMB's recent changes to Circular A–123. Internal control gets to the heart of accountability. The subcommittee's focus on this topic is very timely and most important. Your continuing leadership has been a catalyst to the broad accountability improvements we see across the Government today.

The Congress has long recognized the importance of internal control. Over five decades ago, the Budget and Accounting Act of 1950 placed the responsibility for internal control squarely on the shoulders of management. Management was told that they were responsible for maintaining sound systems of internal control. That was made very, very clear.

In 1982, when faced with a series of major internal control breakdowns, the Congress responded with the Federal Managers' Financial Integrity Act. In many respects, this action by the Congress put us two decades ahead of the private sector, which is now in some cases grappling for the first time with documenting controls and doing some of the things that Federal agencies have been doing for many years.

This straightforward, two-page law reaffirms that sound internal control is a fundamental responsibility of management, and requires that agency heads sign their name on the dotted line each year as to whether their internal control systems meet the requirements established by the Comptroller General. This is where Circular A–123 comes in. It represents OMB's guidance for assessing and reporting on internal control under the act.

In short, we support the recent changes to A–123 and view them as a welcome step forward. We applaud the efforts of the administration to what I call revitalize this important act.

I want to spend a few minutes highlighting what I think will be six issues critical to effectively implementing these changes, and in doing so speaking to some of the lessons learned from the early years of FMFIA. First, we support OMB's plans to provide further implementation guidance. These materials should demand an appropriate rigor to whatever assessment and reporting process management adopts. Management should have flexibility to do what makes sense in their environment.

But at the same time, whatever guidance is issued, everyone must make sure that this does not become a paperwork exercise. In the initial years of FMFIA, agencies almost drowned in paper. Sometimes it seemed that the assessment and reporting process had become the end game. That's why in 1995, OMB relaxed the assessment and reporting requirements. But the pendulum, I think, swung too far then and you saw very mixed implementation of the act. That required the recent recalibration or the changes to Circular A–123, to put this important accountability component fully back on the radar screen. So again, as I mentioned before, this is very, very welcome and very, very timely.

Second, while the revised Circular focuses on internal control over financial reporting, which is very appropriate, agencies must also remain vigilant to the broader range of internal controls that cover program operations, which are exemplified by the 25 areas on GAO's high risk list and are clearly the focus of FMFIA.

Third, there will need to be strong support for managers throughout an agency, both because of the broader nature of FMFIA, about which I just spoke, but also because the CFO typically does not control all the systems and processes needed for financial reporting. For example, at DOD about 80 percent of the information needed for financial reporting comes from non-financial systems, such as logistics, procurement, or personnel systems. These systems are not under the purview of the Comptroller.

Fourth, assessments will have to be risk-based, and the appropriate balance reached between the costs and benefits of controls. In focusing on controls, you need to have the right controls at the right time and the right place, and to guard against both under and over control. I'm speaking not only about having cost-effective processes for assessment but assuring cost-effective controls as well. Because while the Government certainly has serious weaknesses in areas where controls must be strengthened, I think there are many opportunities to streamline and simplify controls as well.

Fifth, management testing of controls in operation will be important to knowing what is working well and what is not. The auditor can be a help here; but this job is a basic ongoing management responsibility and should not be just shifted to the auditor. This is something you've got to be doing day to day, every day.

Sixth, management has to be held accountable for doing the right thing. If there are serious internal control breakdowns and it is determined that management has not been vigilant in implementing FMFIA and following the concepts that are in the OMB circular, there should be some consequence for this. People do react and do act if they see there are incentives and disincentives. I think that was oftentimes lacking in the past.

Annual oversight hearings, combined with linkage to the appropriations process for agencies that are not doing the job, and are valuable tools. And I don't mean that just because an agency has a weakness, that they are not doing the job. They might have inherited some deeply rooted problems they are still working on. So one must make both a qualitative and quantitative decision there. But oversight hearings and the appropriations process are two ways that Congress can make its voice heard and hold managers accountable.

Let me touch on one final matter: auditor opinions on internal control over financial reporting, a concept we have long supported and continue to support. At GAO we practice what we preach. Not only do we render opinions of internal control over financial reporting for the entities that we audit, the Bureau of the Public Debt, IRS, the FDIC, and soon to be SEC, but we also have our independent auditor render an opinion on our internal control over financial reporting.

We believe that the joint GAO-PCIE financial audit manual holds the key to getting this important job done at a reasonable cost. We look forward to working with the CFOs and the IGs as

they conduct the mandated cost benefit study. We want to do this right, and to roll it out in a way that makes sense. I think it should not be a matter of "if" this is ultimately done. It's "when" it's done and if it's done in a way that adds value.

Also as he discussed with you last week in his testimony on the audit of the 2004 consolidated financial statements of the U.S. Government, the Comptroller General has been discussing this issue with the JFMIP principals.

Mr. Chairman, this concludes my summary remarks. I want to again thank you and the members of the subcommittee for your important leadership. I would be pleased to answer any questions that you may have.

[The prepared statement of Mr. Steinhoff follows:]

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Government Management, Finance, and Accountability, Committee on Government Reform, House of Representatives

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FINANCIAL MANAGEMENT

Effective Internal Control Is Key to Accountability

Statement of Jeffrey C. Steinhoff
Managing Director, Financial Management and Assurance

GAO-05-321T

February 16, 2005

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-05-321T, a report to the Subcommittee on Government Management, Finance, and Accountability, Committee on Government Reform, House of Representatives

FINANCIAL MANAGEMENT

Effective Internal Control Is Key to Improving Accountability

Why GAO Did This Study

Internal control is at the heart of accountability for our nation's resources and how effectively government uses them. This testimony outlines the importance of internal control, summarizes the Congress's long-standing interest in internal control and the related statutory framework, discusses GAO's experiences and lessons learned from agency assessments since the early 1980s, and provides GAO's views on the Office of Management and Budget's (OMB) recent revisions to its Circular A-123.

GAO highlights six issues important to successful implementation of the revised Circular, specifically, the need for

1. supplemental guidance and implementation tools;
2. vigilance over the broader range of controls covering program objectives;
3. strong support from managers throughout the agency, and at all levels;
4. risk-based assessments and an appropriate balance between the costs and benefits of controls;
5. management testing of controls in operation to assess if they are designed adequately and operating effectively; and
6. management accountability for control breakdowns.

Finally, GAO discusses its views on the importance of auditor opinions on internal control over financial reporting.

www.gao.gov/cgi-bin/getrpt?GAO-05-321T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact McCoy Williams at (202) 512-6906 or williamsm1@gao.gov.

What GAO Found

Internal control represents an organization's plans, methods, and procedures used to meet its missions, goals, and objectives and serves as the first line of defense in safeguarding assets and preventing and detecting errors, fraud, waste, abuse, and mismanagement. Internal control provides reasonable assurance that an organizations' objectives are achieved through (1) effective and efficient operations, (2) reliable financial reporting, and (3) compliance with laws and regulations.

The Congress has long recognized the importance of internal control, beginning with the Budget and Accounting Procedures Act of 1950, which placed primary responsibility for establishing and maintaining internal control squarely on the shoulders of management. In 1982, when faced with a number of highly publicized internal control breakdowns, the Congress passed the Federal Managers' Financial Integrity Act (FMFIA). FMFIA required agency heads to establish a continuous process for assessment and improvement of their agency's internal control and to annually report on the status of their efforts. In addition the act required the Comptroller General to issue internal control standards and OMB to issue guidelines for agencies to follow in assessing their internal controls.

GAO monitored and reported on FMFIA implementation efforts across the government in a series of four reports from 1984 through 1989 as well as in numerous reports targeting specific agencies and programs. With each report, GAO noted the efforts under way, but also that more needed to be done. In 1989, GAO concluded that while internal control was improving, the efforts were clearly not producing the results intended. The assessment and reporting process itself appeared to have become the endgame, and many serious internal control and accounting systems weaknesses remain unresolved as evidenced by GAO's high risk report which highlights serious long-standing internal control problems.

In 1995, OMB made a major revision to its guidance that provided a framework for integrating internal control assessments with other work performed and relaxed the assessment and reporting requirements, giving the agencies discretion to determine the tools to use in arriving at their annual FMFIA assurance statements. OMB's recent 2004 revisions to the internal control guidance are intended to strengthen the requirements for conducting management's assessment of control over financial reporting.

GAO supports OMB's recent changes to Circular A-123 and in particular the principles-based approach for establishing and reporting on internal control. GAO also noted six specific issues that are important to successful implementation of OMB's revised guidance and discusses its views on the importance of auditor opinions on internal control over financial reporting.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the importance of sound internal control as the foundation of accountability and the recent revisions by the Office of Management and Budget (OMB) to its Circular A-123, *Management's Responsibility for Internal Control.*

Today, I would like to

- highlight the key concepts underlying internal control;
- summarize the Congress's long-standing interest in internal control and the related statutory framework;
- outline early experiences and lessons learned from implementation of 31 U.S.C. 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA);
- provide our views on the recent revisions to Circular A-123 and the issues critical to effectively implementing these changes; and
- discuss our views on the auditor's role in reporting on internal control.

The Key Concepts Underlying Internal Control

Internal control represents an organization's plans, methods, and procedures used to meet its missions, goals, and objectives and serves as the first line of defense in safeguarding assets and preventing and detecting errors, fraud, waste, abuse, and mismanagement. Internal control is to provide reasonable assurance that an organization's objectives are achieved through (1) effective and efficient operations, (2) reliable financial reporting, and (3) compliance with laws and regulations. Safeguarding of assets is a subset of all these objectives. The term "reasonable assurance" is important because no matter how well-designed and operated, internal control cannot provide absolute assurance that agency objectives will be met. Cost-benefit is an important concept to internal control considerations. Internal control is very broad and encompasses all controls within an organization, covering the entire mission and operations, not just financial operations.

One need only to look at GAO's January 2005 *High-Risk Series: An Update*,[1] in which we identify 25 areas of high risk for fraud, waste, abuse, and mismanagement, to see the breadth of internal control. While these areas are very diverse in nature, ranging from weapon systems acquisition to contract management to the enforcement of tax laws to the Medicare and Medicaid programs, all share the common denominator of having serious internal control weaknesses. In addition, as the Comptroller General testified[2] before the House Committee on Government Reform last week, certain material weaknesses in internal control have contributed to our inability to provide an opinion on whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles. Internal control weaknesses are also at the heart of the over $45 billion in improper payments reported by the federal government in fiscal year 2004 across a range of programs. Further, internal control includes things such as screening of air passengers and baggage to help address the risks associated with terrorism, network firewalls to keep out computer hackers, and credit checks to determine the creditworthiness of potential borrowers.

The Congress Has Long Recognized the Importance of Internal Control

The Congress has long recognized the importance of internal control, beginning with the Budget and Accounting Procedures Act of 1950,[3] over 50 years ago. The 1950 act placed primary responsibility for establishing and maintaining internal control[4] squarely on the shoulders of agency management. As I will discuss later, the auditor can serve an important role by independently determining whether management's internal control is adequately designed and operating effectively and making recommendations to management to improve internal control where needed. However, the fundamental responsibility for establishing and maintaining effective internal control belongs to management.

[1]GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

[2]GAO, *Fiscal Year 2004 U.S. Government Financial Statements: Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation's Future Fiscal Challenges*, GAO-05-284T (Washington, D.C.: Feb. 9, 2005).

[3]Budget and Accounting Procedures Act of 1950, ch. 946, 64 Stat. 832 (1950).

[4]The act used the phrase "systems of accounting and internal control."

In 1982, when faced with a number of highly publicized internal control breakdowns, the Congress passed FMFIA[5] with a goal of strengthening internal control and accounting systems. This two-page law, a copy of which is in appendix I, defined internal control[6] broadly to include program, operational, and administrative controls as well as accounting and financial management, and reaffirmed that the primary responsibility for adequate systems of internal control rests with management. Under FMFIA, agency heads are required to establish a continuous process for assessment and improvement of their agency's internal control and to publicly report on the status of their efforts by signing annual statements of assurance as to whether internal control is designed adequately and operating effectively. Where there are material weaknesses, the agency heads are to disclose the nature of the problems and the status of corrective actions in an annual assurance statement. Today, agencies are generally meeting their FMFIA reporting requirement by including this information in their Performance and Accountability reports, which also include their audited financial statements. The act also required that the Comptroller General establish internal control standards and that OMB issue guidelines for agencies to follow in assessing their internal control against the Comptroller General's standards.

OMB first issued Circular A-123, then entitled *Internal Control Systems*, in October 1981, in anticipation of FMFIA becoming law. In December 1982, following FMFIA enactment, OMB issued the assessment guidelines required by the act. OMB's *Guidelines for the Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government* detailed a seven-step internal control assessment process targeted to an agency's mission and organizational structure. The Comptroller General issued *Standards for Internal Control in the Federal Government* in 1983.[7] These standards apply equally to financial and

[5]Pub. L. No. 97-255, 96 Stat. 814 (Sept. 8, 1982). FMFIA was repealed as part of the general revisions to title 31, U.S. Code. The key provisions of FMFIA were codified at 31 U.S.C. § 3512 (c), (d).

[6]FMFIA used the term "internal accounting and administrative controls." OMB initially used the term "management control." In revising Circular A-123 in 2004, OMB replaced the term management control with internal control, to better align with the Comptroller General's internal control standards. Management control and internal control are synonymous.

[7]The Comptroller General revised the standards in 1999, based on developments in internal control theory, the effects of information technology, and the passage of a series of landmark reforms. GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

nonfinancial controls.[8] In August 1984, OMB issued a question and answer supplement to its assessment guidelines, intended to clarify the applicability of the Comptroller General's internal control standards and to assist agencies in assessing risk and correcting weaknesses.

The 1990s brought additional legislation that reinforced the significance of effective internal control. The Chief Financial Officers (CFO) Act,[9] which among other things provided for major transformation of financial management, including the establishment of CFOs, called for financial management systems to comply with the Comptroller General's internal control standards. The Government Performance and Results Act of 1993[10] required agencies to clarify missions, set strategic and performance goals, and measure performance toward those goals. Internal control plays a significant role in helping managers achieve their goals. The Government Management Reform Act of 1994[11] expanded the CFO Act by establishing requirements for the preparation and audit of agencywide financial statements and consolidated financial statements for the federal government as a whole. The 1996 Federal Financial Management Improvement Act[12] identified internal control as an integral part of improving financial management systems. These are just a few of the legislative initiatives over the years aimed at improving government effectiveness and accountability. The Congress has been consistent over the years in demanding that agencies have effective internal control and accounting systems.

Early Experiences and Lessons Learned from Agency FMFIA Implementation

From the outset, agencies faced major challenges in implementing FMFIA. The first annual assessment reports were due by December 31, 1983. This time frame gave agencies a little over a year to develop and implement an agencywide internal control assessment and reporting process to provide the information needed to support the first agency head assurance

[8]The five standards for internal control are (1) control environment, (2) risk assessment, (3) control activities, (4) information and communications, and (5) monitoring.

[9]Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990).

[10]Pub. L. No. 103-62, 107 Stat. 285 (Aug. 3, 1993).

[11]Pub. L. No. 103-356, 108 Stat. 3410 (Oct. 13, 1994).

[12]Pub. L. No. 104-208, div. A §101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

statement to the President and the Congress. OMB assembled an interagency task force called the Financial Integrity Task Force and visited all federal departments and the 10 largest agencies to foster implementation of its internal control assessment guidelines. Starting in 1983, GAO monitored and reported on FMFIA implementation efforts across the government in a series of four reports from 1984 through 1989 as well as in numerous reports targeting specific agencies and programs.

In our first governmentwide report,[13] issued in 1984, we noted that although early efforts were primarily learning experiences, agencies had demonstrated a commitment to implementing FMFIA with a good start at assessing their internal control and accounting systems. We found agencies had established systematic processes to assess, improve, and report on their internal control and accounting systems, and we observed that federal managers had become more aware of the need for good internal control and improved accounting systems. OMB played an active role, providing guidance and central direction to the program. Though the nature and extent of participation varied, most inspectors general also played a major role in the first year. Our 1984 report outlined key steps to improve implementation, including adequate training and guidance, the importance of a positive attitude and a mind-set to hold managers accountable for results, and the need for more internal control testing.

Our second governmentwide report in 1985[14] noted that FMFIA had provided a significant impetus to the government's attempts to improve internal control and accounting systems by focusing attention on the problems. Agencies continued to identify material internal control and accounting system weaknesses with a number of major improvement initiatives under way. We identified needed improvements to FMFIA implementation similar to those in our 1984 report, but also identified the need to reduce the paperwork associated with agency assessment efforts. In particular, vulnerability assessments aimed at identifying the areas of highest risk in order to prioritize more detailed internal control reviews were widely criticized by agencies as paperwork exercises. It was widely thought that while agencies had devoted considerable resources assessing the vulnerability of thousands of operations and functions, these efforts did

[13]GAO, *Implementation of the Federal Managers' Financial Integrity Act: First Year*, GAO/OCG-84-3 (Washington, D.C.: Aug. 24, 1984).

[14]GAO, *Financial Integrity Act: The Government Faces Serious Internal Control and Accounting Systems Problems*, GAO/AFMD-86-14 (Washington, D.C.: Dec. 23, 1985).

not provide management with a whole lot of reliable and useful information.

Our third governmentwide report was issued in 1987.[15] We noted that an important step in strengthening internal control is verifying that planned corrective actions have been implemented as envisioned and that the completed corrective actions have been effective. We found instances where (1) corrective measures taken had not completely corrected the identified weaknesses and (2) actions to resolve weaknesses had been delayed, in some cases for years.

Our fourth governmentwide report,[16] issued in 1989 for which the title, *Ineffective Internal Controls Result in Ineffective Federal Programs and Billion in Losses*, is still appropriate in today's environment, concluded that while internal control was improving, the efforts were clearly not producing the results intended. We noted continuing widespread internal control and accounting system problems and the need for greater top-level leadership. We reported that what started off as a well-intended program to foster the continual assessment and improvement of internal control unfortunately had become mired in extensive process and paperwork. Significant attention was focused on creating a paper trail to prove that agencies had adhered to the OMB assessment process and on crafting voluminous annual reports that could exceed several hundred pages. It seemed that the assessment and reporting processes had, at least to some, become the endgame.

At the same time, there were some important accomplishments coming from FMFIA. Thousands of problems were identified and fixed along the way, especially at the lower levels where internal control assessments were performed and managers could take focused actions to fix relatively simple problems. Unfortunately, many of the more serious and complex internal control and accounting system weaknesses remained largely unchanged and agencies were drowning in paper.

[15]GAO, *Financial Integrity Act: Continuing Efforts Needed to Improve Internal Control and Accounting Systems*, GAO/AFMD-88-10 (Washington, D.C.: Dec. 30, 1987).

[16]GAO, *Financial Integrity Act: Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses*, GAO/AFMD-90-10 (Washington, D.C.: Nov. 28, 1989).

In March 1989, GAO, along with representatives of seven agencies, OMB, and the President's Council on Integrity and Efficiency (PCIE),[17] reviewed aspects of FMFIA implementation as part of a subcommittee of the Internal Control Interagency Coordination Council. The subcommittee's report highlighted the following seven issues as requiring action:

- Link the internal control assessment and reporting process with the budget to assist the Congress and OMB in analyzing the impact of corrective actions on agency resources.
- Emphasize the early warning capabilities of the internal control process to ensure timely actions to correct weaknesses identified.
- Consolidate the review processes of various OMB circulars to eliminate overlapping assessment requirements, improve staff utilization, and reduce the paper being generated.
- Provide for and promote senior management involvement in the internal control process to ensure more effective and lasting oversight and accountability for FMFIA activities.
- Highlight the most critical internal control weaknesses in the FMFIA assurance statements to increase the usefulness of the report to the President and the Congress.
- Report on agency processes to validate actions taken to correct material weaknesses, ascertain that desired results were achieved, and reduce the likelihood of repeated occurrences of the same weaknesses.
- Improve management awareness and understanding of FMFIA to provide for more consistent program manager interpretation and acceptance of the act.

Too much process and paper continued to be a problem, and in 1995 OMB made a major revision to Circular A-123 that relaxed the assessment and reporting requirements. The 1995 revision integrated many policy issuances on internal control into a single document and provided a framework for integrating internal control assessments with other reviews

[17]PCIE was established to address integrity, economy, and effectiveness issues that transcend individual government agencies.

being performed by agency managers, auditors, and evaluators. In addition, it gave agencies the discretion to determine which tools to use in arriving at the annual assurance statement to the President and the Congress, with the stated aim of achieving a streamlined management control program that incorporated the then administration's reinvention principles.

Revised OMB Circular A-123 Marks an Important Step toward Achieving FMFIA Objectives

And this brings us to the present. The recent December 2004 update to Circular A-123 reflects policy recommendations developed by a joint committee of representatives from the CFO Council (CFOC)[18] and PCIE.[19] The changes are intended to strengthen the requirements for conducting management's assessment of internal control over financial reporting. The December 2004 revision to the Circular also emphasizes the need for agencies to integrate and coordinate internal control assessments with other internal control-related activities.

We support OMB's efforts to revitalize FMFIA through the December 2004 revisions to Circular A-123. These revisions recognize that effective internal control is critical to improving federal agencies' effectiveness and accountability and to achieving the goals that the Congress established in 1950 and reaffirmed in 1982. The Circular correctly recognizes that instead of considering internal control an isolated management tool, agencies should integrate their efforts to meet the requirements of FMFIA with other efforts to improve effectiveness and accountability. Internal control should be an integral part of the entire cycle of planning, budgeting, management, accounting, and auditing. It should support the effectiveness and the integrity of every step of the process and provide continual feedback to management.

In particular, we support the principles-based approach in the revised Circular for establishing and reporting on internal control that should increase accountability. This type of approach provides a floor for expected behavior, rather than a ceiling, and by its nature, greater judgment on the part of those applying these principles will be necessary.

[18]CFOC is an organization of the CFOs and deputy CFOs of the largest federal agencies, and senior officials of OMB and the Department of the Treasury who work collaboratively to improve financial management in the U.S. government.

[19]Both PCIE and CFOC are chaired by OMB's Deputy Director for Management.

Accordingly, clear articulation of objectives, the criteria for measuring whether the objectives have been successfully achieved, and the rigor with which these criteria are applied will be critical. Providing agencies with supplemental guidance and implementation tools is particularly important, in light of the varying levels of internal control maturity that exist across government as well as the expected divergence in implementation that is typically found when a range of entities with varying capabilities apply a principles-based approach.

I would now like to highlight what I think will be the six issues critical to effectively implementing the changes to Circular A-123 based on the lessons learned over the past 20 years under FMFIA.

First, OMB indicated that it plans to work with the CFOC and PCIE to provide further implementation guidance. For the reasons I just highlighted, we support the development of supplemental guidance and implementation tools, which will be particularly important to help ensure that agency efforts are properly focused and meaningful. These materials should demand an appropriate rigor to whatever assessment and reporting process management adopts as well as set the bar at a level to ensure that the objectives of FMFIA are being met in substance, with a caution to guard against excessive focus on process and paperwork. Supplemental guidance and implementation tools should be aimed at helping agency management achieve the bottom-line goal of getting results from effective internal control.

Second, while the revised Circular A-123 emphasizes internal control over financial reporting, it will be important that proper attention also be paid to the other two internal control objectives covered by FMFIA and discussed in the Circular, which are (1) achieving effective and efficient operations and (2) complying with laws and regulations. Also, as I mentioned earlier, safeguarding assets is a subset of all three objectives.

Third, managers throughout an agency and at all levels will need to provide strong support for internal control. As I discussed earlier, the responsibility for internal control does not reside solely with the CFO. A case in point is internal control over improper payments, which is the responsibility of a range of agency officials outside of the CFO operation. Also, with respect to financial reporting, which the revised OMB Circular A-123 specifically refers to as a priority area, the CFO generally does not control all of the needed information and often depends on other business systems for much of the financial data. For example, at the Department of

Defense (DOD), about 80 percent of the information needed to prepare annual financial statements comes from other business systems, such as logistics, procurement, and personnel information systems, that are not under the CFO.

Fourth, agencies must strike an appropriate balance between costs and benefits, while at the same time achieving an appropriate level of internal control. Internal controls need to be designed and implemented only after properly identifying and analyzing the risks associated with achieving control objectives. Agencies need to have the right controls, in the right place, at the right time, with an appropriate balance between related costs and benefits. In this regard, the revisions to Circular A-123 outline the concept of risk assessment for internal control over financial reporting by laying out an assessment approach at the process, transaction, and application levels. A similar approach needs to be applied as well to the other business areas and the range of programs and operations as envisioned in FMFIA.

Fifth, management testing of controls in operation to determine their soundness and whether they are being adhered to and to assist in the formulation of corrective actions where problems arise will be essential. This is another area covered by the revised Circular A-123. Testing can show whether internal controls are in place and operating effectively to minimize the risk of fraud, waste, abuse, and mismanagement and whether accounting systems are producing accurate, timely, and useful information. Through adequate testing, agency managers should know what is working well and what is not. Management will then be able to focus on corrective actions as needed and on streamlining controls if testing shows that existing controls are not cost-effective.

Sixth, personal accountability for results will be essential, starting with top agency management and cascading down through the organization. Regular oversight hearings, such as this one, will be critical to keeping agencies accountable and expressing the continual interest and expectations of the Congress. Independent verification and validation through the audit process, which I will talk about next, is another means of providing additional accountability. There should be clear rewards (incentives) for doing the right things and consequences (disincentives) for doing the wrong things. If a serious problem occurs because of a breakdown in internal control and it is found that management did not do its part to establish a proper internal control environment, or did not act expeditiously to fix a known problem, those responsible need to be held

accountable and face the consequences of inaction. The revised Circular A-123 encourages the involvement of senior management councils in internal control assessment and monitoring, which can be an excellent means of establishing accountability and ownership for the program.

The Auditor's Role in Evaluating Management's Internal Control Efforts

In initiating the revisions to Circular A-123, OMB cited the new internal control requirements for publicly traded companies that are contained in the Sarbanes-Oxley Act of 2002.[20] Sarbanes-Oxley was born out of the corporate accountability failures of the past several years. Sarbanes-Oxley is similar in concept to the long-standing requirements for federal agencies in FMFIA and Circular A-123. Under Sarbanes-Oxley, management of a publicly-traded company is required to (1) annually assess the internal control over financial reporting at the company and (2) issue an annual statement on the effectiveness of internal control over financial reporting.[21] The company's auditors are then required to attest to and report on management's assessment as to the effectiveness of its internal control. This is where Sarbanes-Oxley differs from FMFIA. FMFIA does not call for an auditor opinion on management's assessment of internal control over financial reporting nor does it call for an auditor opinion on the effectiveness of internal control. Likewise, Circular A-123 does not adopt these requirements, although the Circular does recognize that some agencies are voluntarily getting an audit opinion on internal control over financial reporting.

Our position is that an auditor's opinion on internal control over financial reporting is similarly important in the government environment. We view auditor opinions on internal control over financial reporting as an important component of monitoring the effectiveness of an entity's risk management and accountability systems. In practicing what we preach, we not only issue an opinion on internal control over financial reporting at the federal entities where we perform the financial statement audit,[22] including

[20]Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

[21]See Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 *Fed. Reg.* 36635 (June 18, 2003) (codified at scattered sections of title 17, *Code of Federal Regulations*).

[22]Currently, we perform financial statement audits at the Federal Deposit Insurance Corporation, the Internal Revenue Service, the Bureau of the Public Debt, and the Securities and Exchange Commission.

the consolidated financial statements of the U.S. government, but we also obtain an auditor's opinion on internal control on our own annual financial statements. On their own initiative, the Social Security Administration (SSA) and Nuclear Regulatory Commission also received opinions on internal control over financial reporting for fiscal year 2004 from their respective independent auditors.

In considering when to require an auditor opinion on internal control, the following four questions can be used to frame the issue.

1. Is this a major federal entity, such as the 24 departments and agencies covered by the CFO Act? There would be different consideration for small simple entities versus large complex entities.

2. What is the maturity level of internal control over financial reporting?

3. Is the agency currently in a position to attest to the effectiveness of internal control over financial reporting and subject that conclusion to independent audit?

4. What are the benefits and costs of obtaining an opinion?

What underlies these questions is whether management has done its job of assessing its internal control and has a firm basis for its assertion statement before the auditor is tasked with performing work to support an opinion on internal control over financial reporting. As I have stressed throughout my testimony today, internal control is a fundamental responsibility of management, including ongoing oversight. The auditor's role, similar to its opinion on the financial statements issued by management, would be to state whether the auditor agrees [23] with management's assertion that its internal control is adequate so that the reader has an independent view.

As an example, consider DOD which has many known material internal control weaknesses. Of the 25 areas on GAO's high-risk list, 14 relate to DOD, including DOD financial management. Given that DOD management is clearly not in a position to state that the department has effective internal control over financial reporting, there would be no need for the auditor to

[23] If the auditor follows the joint GAO/PCIE *Financial Audit Manual* (FAM), as is expected for federal financial statement audits, the work performed should be adequate to render an opinion on internal control.

do additional audit work to render an opinion that internal control was not effective. On the other hand, as I just mentioned for fiscal year 2004, SSA management reported that it does not have any material internal control weaknesses over financial reporting. The auditor's unqualified opinion over financial reporting at SSA provided an independent assessment of management's assertion about internal control, which we believe by its nature adds value and creditability similar to the auditor's opinion on the financial statements.

As you know, Mr. Chairman, recent legislation[24] making the Department of Homeland Security (DHS) subject to the provisions of the CFO Act, which this Subcommittee spearheaded, requires DHS management to provide an assertion on the effectiveness of internal control over financial reporting for fiscal year 2005 and to obtain an auditor's opinion on its internal control over financial reporting for fiscal year 2006. In addition, the CFO Council and PCIE are required by the DHS legislation to jointly study the potential costs and benefits of requiring CFO Act agencies to obtain audit opinions on their internal control over financial reporting, and GAO is to perform an analysis of the information provided in the report and provide any findings to the House Committee on Government Reform and the Senate Committee on Homeland Security and Governmental Affairs.[25] We believe that the study and related analysis are important steps in resolving the issues associated with the current reporting on the adequacy of internal control. In addition, this issue is being discussed by the Principals of the Joint Financial Management Improvement Program—the Comptroller General, the Director of OMB, the Secretary of the Treasury, and the Director of the Office of Personnel Management.

In closing, as the Congress and the American public have increased demands for accountability, the federal government must respond by having a high standard of accountability for its programs and activities. Areas vulnerable to fraud, waste, abuse, and mismanagement must be continually evaluated to ensure that scarce resources reach their intended beneficiaries; are used properly; and are not diverted for inappropriate, illegal, inefficient, or ineffective purposes.

[24]Pub. L. No. 108-330, 118 Stat. 1275 (Oct. 16, 2004).

[25]Since passing the legislation, the Senate Committee on Governmental Affairs changed its name to the Senate Committee on Homeland Security and Governmental Affairs.

I want to emphasize our commitment to continuing our work with the Congress, the administration, the federal agencies, and the audit community to continually improve the quality of internal control governmentwide, and to help ensure that action is taken to address the internal control vulnerabilities that exist today. To that end, as I said earlier, the leadership of this Subcommittee will continue to be an important catalyst for change, and I again thank you for the opportunity to participate in this hearing.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

Contacts and Acknowledgments

For information about this statement, please contact Jeffrey C. Steinhoff at (202) 512-2600 or McCoy Williams, Director, Financial Management and Assurance, at (202) 512-6906 or at williamsm1@gao.gov. Individuals who made key contributions to this testimony include Mary Arnold Mohiyuddin, Abe Dymond, and Paul Caban. Numerous other individuals made contributions to the GAO reports cited in this testimony.

Federal Managers' Financial Integrity Act of 1982

Federal Managers' Financial Integrity Act of 1982

Public Law 97–255

(96 Stat. 814)

AN ACT To amend the Accounting and Auditing Act of 1950 to require ongoing evaluations and reports on the adequacy of the systems of internal accounting and administrative control of each executive agency, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. This Act may be cited as the "Federal Managers' Financial Integrity Act of 1982". *(31 U.S.C. 65 note).*

SEC. 2. Section 113 of the Accounting and Auditing Act of 1950 (31 U.S.C. 66a) is amended by adding at the end thereof the following new subsection:

"(d)(1)(A) To ensure compliance with the requirements of subsection (a)(3) of this section, internal accounting and administrative controls of each executive agency shall be established in accordance with standards prescribed by the Comptroller General, and shall provide reasonable assurances that—

"(i) obligations and costs are in compliance with applicable law;

"(ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and

"(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

"(B) The standards prescribed by the Comptroller General under this paragraph shall include standards to ensure the prompt resolution of all audit findings.

"(2) By December 31, 1982, the Director of the Office of Management and Budget, in consultation with the Comptroller General, shall establish guidelines for the evaluation by agencies of their systems of internal accounting and administrative control to determine such systems' compliance with the requirements of paragraph (1) of this subsection. The Director, in consultation with the Comptroller General, may modify such guidelines from time to time as deemed necessary.

"(3) By December 31, 1983, and by December 31 of each succeeding year, the head of each executive agency shall, on the basis of an evaluation conducted in accordance with guidelines prescribed under paragraph (2) of this subsection, prepare a statement—

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"(A) that the agency's systems of internal accounting and administrative control fully comply with the requirements of paragraph (1); or

"(B) that such systems do not fully comply with such requirements.

"(4) In the event that the head of an agency prepares a statement described in paragraph (3)(B), the head of such agency shall include with such statement a report in which any material weaknesses in the agency's systems of internal accounting and administrative control are identified and the plans and schedule for correcting any such weakness are described.

"(5) The statements and reports required by this subsection shall be signed by the head of each executive agency and transmitted to the President and the Congress. Such statements and reports shall also be made available to the public, except that, in the case of any such statement or report containing information which is—

"(A) specifically prohibited from disclosure by any provision of law; or

"(B) specifically required by Executive order to be kept secret in the interest of national defense or the conduct of foreign affairs, such information shall be deleted prior to the report or statement being made available to the public.".

SEC. 3. Section 201 of the Budget and Accounting Act, 1921 (31 U.S.C. 11), is amended by adding at the end thereof the following new subsection:

"(k)(1) The President shall include in the supporting detail accompanying each Budget submitted on or after January 1, 1983, a separate statement, with respect to each department and establishment, of the amounts of appropriations requested by the President for the Office of Inspector General, if any, of each such establishment or department.

"(2) At the request of 8 committee of the Congress, additional information concerning the amount of appropriations originally requested by any office of Inspector General, shall be submitted to such committee.".

SEC. 4. Section 113(b) of the Accounting and Auditing Act of 1950 (31 U.S.C. 66a(b)), is amended by adding at the end thereof the following new sentence: "Each annual statement prepared pursuant to subsection (d) of this section shall include a separate report on whether the agency's accounting system conforms to the principles, standards, and related requirements prescribed by the Comptroller General under section 112 of this Act.". *(31 U.S.C. 66a).*

Approved September 8, 1982.

[1]This Act has not been amended as of December 31, 1996.

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Mr. PLATTS. Thank you, Mr. Steinhoff.

Before we continue, I would like to recognize that we have been joined by the gentlelady from New York, Mrs. Maloney. Thank you.

We will go right into questions, and we will do 5 minutes or so for each Member and have various rounds. Mr. Steinhoff, I want to first comment on your work and sitting here with two CFOs, and as one who played an integral role in the CFO Act back in 1990, and now partnering with our CFOs and our IGs in this collaborative effort, what important work it is. Your comment about the A–123 Circular revision revitalizing FMFIA is, a very important note. And that's really what this subcommittee, through our work on the DHS bill last session and now continuing with our oversight responsibilities on the Circular, is seeking to do.

Mr. STEINHOFF. Mr. Chairman, I would like to add another point to that. When you mentioned the CFO Act, at the time of FMFIA, agencies really weren't in the same position as they are today. You didn't have, for the most part, what I would call professional CFOs. And you have a much different set of dynamics today. You have that act and that structure in place to carry a lot of this out.

Mr. PLATTS. That evolution, 50 years ago, when as you referenced the legislation back in 1950 and now through to this day, combined with everything in between, has put, I believe, the Federal Government in a great position to really work hard at truly getting its financial house in order. And that's what each of you is seeking to do in your individual agencies or in a collaborative effort as members of the PCIE or CFO Council and with GAO. So we're delighted to have your efforts out there and have you here today.

What I thought, maybe for each of our CFOs and IGs, if all or one of you would want to give, just in laymen's terms, an example of an internal control in your department, just to kind of set the stage for what we are talking about, the kinds of things that should be occurring to protect taxpayer funds in each of your departments.

Mr. WOLFF. I'd be happy to try and answer that, Mr. Chairman. I think internal controls come at all levels, at the macro level and a micro level. Where we start in our department is leadership at the top. We have a new Secretary of our Department, Carlos Guittierez, who was previously the head of Kellogg Corp. He turned that corporation around, and he has been here a week. He had his first meeting with the senior staff early this weekend. One of the first things he emphasized was accountability, by his managers sitting around the table, by his senior staff and throughout the organization.

It starts at the top. It's our responsibility to inculcate the culture from the top all the way down to the bottom. Concurrent with that, I meet with the CFOs in all our bureaus on a monthly basis. So those are the macro kinds of controls. The other kinds of things, the reviews you do of travel reports and those kinds of things. Those would be examples of micro level of internal controls.

Mr. PLATTS. OK. Mr. Burnham.

Mr. BURNHAM. Thank you, Mr. Chairman.

Like the Department of Commerce, we have a new Secretary as well. I think it is indicative of her, of the emphasis she places on management, that her first briefing while she was going through

the confirmation process was from the management bureaus of the State Department and the Under Secretary for Management. So clearly, we have top down support and focus on this effort. We have a best practice that is held up by OMB as a best practice. It's also at the macro level. And of course, we know that it flows downhill, so it has to start there.

We have a management control steering committee. This is the most important thing that agencies can implement. This is chaired by me as the Assistant Secretary and Chief Financial Officer. It also consists of nine other assistant secretaries and the IG as a non-voting member. This is the group that comes together on a regular basis to determine whether or not we have material weaknesses, reportable conditions. We receive a report from the auditor.

Government is a hybrid. We have no board of directors. You are our board of directors. But yet, unlike a board of directors, we don't have an audit committee. We do have an IG, but we do not have yet an internal audit capability, but we certainly plan to as part of our process of seeking and attaining an outside audit of our internal controls.

But it starts there at that senior level committee that is going to provide the top down guidance, the macro guidance, that's going to go all the way down.

Let me just also mention too at the micro level. It's supervisory oversight as well, and you mentioned one of these in your example. But it's also peer review, peer review in terms of making sure that it doesn't always have to be a supervisor, it can also be a colleagues in a voucher examiner capacity also doing a peer review on someone else. These are the kinds of things we have to do at the State Department.

Mr. PLATTS. Thank you.

Before I yield to the ranking member, we are going to get into the A–123 Circular. One aspect of that implementation is with the CFO Council developing a training program or guidance for the effective implementation. Could you give us an update where that process is and what kind of timeframe we're looking at to have that information, that assistance out there, so that all the departments and agencies can go forward in a positive way with the new Circular?

Mr. BURNHAM. We are fleshing that out right now, Mr. Chairman. We anticipate that we will be able to, that OMB will be able to issue guidance on that some time in the spring, that's as close as I can get it right now, sir.

And we have established a separate subcommittee of the CFO Council that is dealing exclusively with this issue, the Sarbanes-Oxley, with A–123 issues.

Mr. PLATTS. When you flesh that out and you have some of your training programs for your managers, will that training be cross-agency, cross-department, to allow that give and take as the CFO Council does at the senior level, or will it be more within each department or agency?

Mr. BURNHAM. No, as a matter of fact, I also chair the Best Practices of the CFO Council. Just yesterday we had our monthly meeting, in fact, this was brought up. We plan to have a couple of different ways, not only in terms of written guidance, in terms of

training sessions across agency, inter-agency, not just for CFOs, but also for our colleagues within the community.

We also are looking at building a panel so that during our regular monthly meeting we would bring a panel of outside experts that would come in and tell us how they have implemented this in the corporate world. We are also seeking a panel, sir, of public policy experts, those of you who visit this on a daily basis. You, perhaps Congressman Oxley and others, sir, we would love to have come before the Council and give us your impression.

Finally, we are looking to do a retreat. We get bombarded with e-mails for all kinds of retreats. I'm sure you do as well. We can go to Harvard, we can go to all these kinds of places for 3, 4, 5 days, they cost thousands of dollars. We're looking actually to build possibly in conjunction with the Association of Government Accountants a retreat where from the assistant secretary level and below we can send numerous people, come there and really have an intense two, three in-depth training session on this.

Mr. PLATTS. I commend your efforts in chairing the Best Practices subcommittee in that learning, benefiting from each other. That's great.

Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Mr. Steinhoff, let me start with you. How can an agency like NASA, with the vast majority of the budget being allocated to private contractors and vendors, ever improve their internal control functions without streamlining their procurement activities? Have issues concerning the lack of control over property, plant and equipment been addressed by the agency?

Mr. STEINHOFF. Congressman Towns, those are areas on GAO's high risk list. NASA procurement and that whole array you were just speaking about are high risk areas. NASA faces contract management challenges. They face challenges in the financial management as well. NASA has had problems bringing up financial systems that operate effectively and is trying to grapple with those now.

You are really putting your finger on some high risk areas, that really affect the ability of NASA to carry out its mission, because NASA is dependent on the contract community. And when contracting, procurement, and all that oversight is a high risk area, it makes it difficult. My understanding is that at one time NASA built the platforms and all that itself. It had most of the scientific community. Today, as you stated, they are largely dependent on contractors. So getting on top of contract management is very, very important.

Mr. TOWNS. Thank you.

I am not going to be able to stay throughout, so let me ask this question just in case the chairman doesn't ask it, let me ask it. Since the enactment of Chairman Platts' legislation that requires an independent opinion of DHS' internal controls, can you update us on any progress the agency may have made for developing and implementing improvements to their internal control structure? Have the efforts of DHS been hampered because of the distinct nature of its legacy agencies, or are they similar to internal control deficiencies at other Federal departments?

Mr. STEINHOFF. I have some knowledge on this. DHS is another area on our high risk list. Certainly when you put a new department together, 1 day they don't exist, the next day they do, and you throw together a bunch of groups, that makes it hard. Many of those units that were merged into DHS had internal control issues coming in. Some had serious control problems coming in. So you had to face having to be up and running from day one without a clear infrastructure at the department level. Again, our high risk designation focuses on that problem.

With respect to what they are doing to really address the mandate that the chairman had placed in the DHS bill, I can't speak to the progress they have made today, other than the fact that they had a conference, the Comptroller General spoke at it, and they made a presentation on their plans for implementing FMFIA and OMB Circular A–123.

It seemed to me they had a good grasp for how to approach this. It seemed to me they were involving all the entities, all the activities. They had various levels of steering committees that involved their various components, and involved people at sufficiently high levels that things should in fact be achieved. So they seemed earnest, they seemed to want to proceed ahead, they seemed to want to get on top of their problems.

But they do face what anyone would say are high risk challenges. It would be again very challenging for them.

Mr. TOWNS. Thank you very much.

Secretary Burnham, it recently came to our attention that billions of dollars allocated by Congress toward the international efforts in Iraq and elsewhere are unaccounted for. While I understand that your agency's mission is distinct from that of DOD can you offer us any assurance that our appropriations in support of our international efforts within the State Department are being well managed and controlled? Are there any allocation discrepancies within your agency that we should be made aware of?

Mr. BURNHAM. Mr. Towns, thank you for that question. Let me address just post-turnover, when Ambassador Negroponte arrived in Baghdad. Let me just say that most of the programs that we are implementing through foreign assistance programs and through the Iraqi Relief and Reconstruction Fund are being executed by either DOD, which I will not comment on, although I have complete faith in, and USAID. USAID has a legacy of exceptional controls that they place through their comptroller's office, through independent audits, not just only in Iraq, but in every country where AID operates. They have very strong oversight programs. I have complete faith in what AID is doing, particularly under the leadership of Administrator Andrew Natsios.

So, sir, if you would accept my assurance that I have full faith as an American taxpayer in what we're doing there and what our State Department is doing there, and what AID is doing there, then if you'll accept that, sir, I'll leave it at that.

Mr. TOWNS. Thank you very much. We're going to have to go into recess, Jim had to leave to vote, and I must leave to go somewhere. We will just have a 5-minute recess.

[Recess.]

Mr. PLATTS. We will reconvene the hearing. My apologies for the delay. Unfortunately, I may need to run out again. We have a markup in the Education Committee downstairs. I'm getting my exercise today. Hopefully the next vote will be a little while before they call it.

I want to continue on a number of issues here. One important aspect of the A–123 Circular, is not requiring every department and agency to have an audit opinion on their internal controls, as we are doing with DHS. We are going to look at the cost benefit of doing that in a broader sense. As written, it gives OMB that discretion. I would like each of you, if you could touch on what type of threshold you envision for when OMB should invoke that discretion and require an audit. Is it a dollar amount, is it a persistent number of years? What in your opinion would warrant an audit opinion on the internal controls?

Mr. WOLFF. I suppose I should let the Government Accountability Office go first on this one, sir, but I will take a stab at it. It seems to me you can't put a dollar threshold on implementing this provision of A–123. I think it is more a subjective call on how an agency is doing. Are they properly identifying their internal controls? Are they carrying out the plans that they have set in place to correct those internal controls, and are they doing it in a timely way?

I think that is the bottom line on the call at OMB. You can't just set a dollar threshold, because what might be material at the Department of Defense may not be in one of our sub-bureaus, for example. There is a great debate going on at each agency right now about this materiality issue. It is one that is fairly well parochialized because of the difference in programs across Government.

That's the short answer, I think, sir, to what you are asking.

Mr. BURNHAM. Mr. Chairman, stewardship has no price. I think we all agree on that in the room. It doesn't mean that we spend a nickel to account for a nickel. But it does mean that we have to eventually get to a point where we have required audits of our internal controls.

For the State Department, that means $4.5 million is our best guess at this point, 2 to 3 years. It has to do with testing. It has to do with documentation. And finally, it has to do with building what we call a senior review committee, otherwise known in the outside world as an internal audit capability. We want to be very respectful of our IG, but the reality is that we should all have an internal audit capability or internal senior review committee.

When those three things are well on their way, when using the balance score card, OMB can say that most agencies are at yellow, if not green for progress, yellow for status, then I think it's time for OMB or the Congress to act. I don't think it's 2 years, but I think certainly within the next 5, sir.

Mr. PLATTS. Thank you.

Mr. HIGGINS. I think that one of the things you have to take into consideration initially is the cost benefit of this opinion. Certainly it would be a concern from my perspective if you had repeat findings that continued year after year without being corrected.

But I do think the first thing you have to do is look at the cost benefit of this, how much it is going to cost you and what you are going to get out of it.

Mr. STEINHOFF. A couple of thoughts on this, since we have been pretty vocal for many years on this matter. Not only do we do it, but really in a strict technical sense, we're not required to follow FMFIA. The law doesn't really apply to GAO per se. But we follow that law.

I agree with what Mr. Burnham said. I think the agency has to see where they are on this. I believe it can be done in a cost-effective manner. It should be a by-product of doing a financial audit using the joint GAO/PCIE Financial Audit Manual, which I think has taken us to the level that we are doing first rate financial audits. I would put the Federal financial audits ahead of what was being done in the private sector in terms of quality. It gives the auditor the ability to render an opinion on controls. We do it right now by following the GAO/PCIE methodology.

I think you have to look at the value in terms of that, it's an independent set of eyes. When agencies were first required to prepare financial statements, there was a lot of the same thinking that it was not cost effective to audit the financial statements you know, let's just send in the reports. So what an audit opinion provides is a second, independent set of eyes. And it is providing an assurance.

If you look at SSA, which I really think is the role model, they voluntarily prepared financial statements and had them audited in the mid-1980's. They took their lumps long before there was any glimmer that this thing was ever going to become law. And they are now one of the first to be up front and get an opinion on controls. I believe this year was the first year they got a clean opinion on controls because they were able to get past the computer security hurdle, which is a difficult hurdle. That's a tough hurdle, even if you get by it once.

SSA should be most proud of the fact that on their own volition they have had that tone at the top and have pushed ahead, as Mr. Burnham explained was his goal at State, and have voluntarily done so. But I think it is really a cost of doing business in Government. I think we can do it in a cost-effective manner. I think it can add value. If management does have the kind of internal control program in place that is envisioned in A–123, it makes the auditor's job a lot easier, because management has tested its controls. Management has a basis for its assurance, and management can say to you that yes, we do meet the standard and this is what we base that on.

If you have an entity that has lots and lots of problems and they can't provide that assurance, I could see the auditor's job being very easy, they don't have assurance. It shouldn't cost the auditor anything. Take DOD, I could give that opinion in just the time it would take me to write it up.

So I think moving through in an orderly manner, whether it's 2, 3, 4, 5 years, it would differ by agency, makes a lot of sense.

Mr. PLATTS. Secretary Burnham, your statement was that you envision State being at that point in 2 to 3 years, right?

Mr. BURNHAM. Yes. I would anticipate regardless that we will have an internal audit of our internal controls within the next 2 to 3 years. I think as I said, it will cost $4 million to $5 million to get there because of the three steps that we have to take. Then I think beyond that it's fairly de minimis. It's perhaps a 25 to 50 percent increase in our overall independent outside audit, which right now stands just below $1 million.

Mr. PLATTS. Secretary Wolff.

Mr. WOLFF. May I just add, Mr. Chairman, the comments of my friends, notwithstanding, I don't think we can underestimate the cost. I think we run the risk of underestimating the true costs of the audit part of this provision. There is no question in my mind that the exercise is beneficial. No one is arguing that.

But when you do audits of the Social Security Administration's internal controls, it is quite different, they are a single focus agency. As important as they are, it's a single focus. They pay folks checks.

When you have an agency as diverse as ours, where you've got everything from counting all the people in the country every 10 years with 500,000 employees to running weather satellites to controlling radio spectrum, the costs start going up considerably. That, coupled with the open source news reports in the Wall Street Journal, the Financial Times and others in which the cost of the additional burden in the private sector ranges anywhere upward to 100 percent over current audit costs, we need to very closely look at that before we start mandating these things absent additional funding from the Congress.

Mr. PLATTS. Secretary Wolff, is it fair to say, though, that given the complexity of Commerce or State or Education that because you are not single focused, really, as Social Security is, it's all the more important that we ensure that your internal controls are up to the challenge before you? It would make the argument why you should be doing them because of the complexity of your mission.

Mr. WOLFF. Sir, we are already hard at work documenting our internal controls. I am not arguing with that. I think it is a very worthwhile exercise.

As far as annual audit opinions, though, of the management's assertions and internal controls, it's quite a different story. I think we need to look at it very closely. This interagency review that's being undertaken jointly with the PCIE and the CFO Council will hopefully lead us to a satisfactory conclusion.

Mr. PLATTS. Actually, you led into my next question, which was, under my DHS legislation, the requirement for this joint study, cost benefit study, I was wondering, between CFOs and our Inspector General where we are in that review, that study, at this point. Are we still kind of early on?

Mr. WOLFF. Yes, sir, pretty early on.

Mr. PLATTS. OK. Great.

Mr. BURNHAM. Mr. Chairman, can I just add one thing to my colleague, Secretary Wolff? He did bring up a very important point. From my own legislation days, I know how objectionable we found it when we had to vote on something which was an unfunded mandate. The importance, of course, of understanding that, finding $4.5 million in the State Department budget, is going to be a difficult

task. So unless we do have support across the board, both from our own colleagues as well as from the Congress, it is going to be very tough to implement this. So we certainly would urge you, sir, to work with the appropriators in full support.

Mr. PLATTS. That leads nicely into the next question I have, but I have to run downstairs and put a vote in. I apologize, but if you are patient, I will be right back and we will continue the dialog. We stand in recess for a few minutes.

[Recess.]

Mr. PLATTS. The subcommittee will reconvene.

The Federal Managers Financial Integrity Act, having been in place for 23 years now, an aspect of that was to focus on the internal controls. Is it that what we are requiring now is so much greater that we have this infrastructure buildup, that we need to expend these dollars to get up to where we can do internal audits or is it that over those 20 years there wasn't the level of focus and commitment on internal controls as Congress intended when FMFIA was passed that we're now kind of all on the same page, finally, with the new Circular and really making the investment?

Mr. WOLFF. Sir, I think Mr. Steinhoff touched on that a little bit in his testimony. Back in the 1980's, there was a great deal of attention, as you probably know, given to internal controls. It became as he said, a paper intensive process. The documentation of the process became an end unto itself.

So the internal control weaknesses remained while the process was fine. So that's what led the administration, back in 1995, apparently, to make the judgment that they should back off on the requirement for the reporting part of it. I think the pendulum, as he said, did swing too much the other way and now we're back, and with a different focus. The documentation requirement is there, but it's more an inculcation of the culture rather than a paper process. So there's a huge difference.

Mr. PLATTS. Maybe we can explore in that difference, because a big part of the audit is compliance with all the laws and regulations of each department and agency. Would it be logical to require your Department's auditor to get an opinion on compliance with FMFIA and how would that opinion differ from an actual opinion on your internal controls?

Mr. STEINHOFF. Yes, FMFIA requires management to have an evaluation process that meets the guidelines that are established by OMB. If you are going to give an opinion on that, you would basically say whether or not management was assessing its controls in some orderly manner that made sense, was in a position to put its assurance statement together, and had in fact rendered the report that the law required it to render. You wouldn't, though, be giving an opinion on the controls themselves. You would be giving an opinion on the process they followed.

Going back, and I apologize for being back here a minute late.

Mr. PLATTS. I was quick.

Mr. STEINHOFF. You were very quick. In looking at the 1982 act, you really had such a steep learning curve that agencies didn't know what to do. But they had to immediately be doing something. There was this tremendous cry for a lot of specific guidance. So what you had was in-depth guidance that would be used by an

auditor to do a vulnerability assessment or internal control review, massive training and a lot of very specific things.

It really drove people to just generate lots of paper to be trying to comply with a very rigorous evaluation process for which they did not understand the principles undergirding it. You had entities that might have 30,000 or 40,000 assessable units and each unit would apply an assessment guide. Then they would roll it up at all these levels. It just became a blizzard of paper.

My job for about 10 years was overseeing all this. It got worse and worse as people became more sophisticated in the process. It really took hold. They worked very hard. I would give them an A for effort. But we ended up with too much paper, and finally that pendulum swung and OMB basically said, forget the whole thing. I think it fell off the radar screen around 1995. Now it's back on, which I think is very positive.

Mr. PLATTS. Secretary Burnham, did you have something you wanted to say?

Mr. BURNHAM. No, I just, while you left the room, I got into a little bit of hot water with my colleagues. They said I was jumping the gun.

Mr. PLATTS. On the 2 to 3 years? [Laughter.]

Mr. BURNHAM. They didn't use the word showboat, but—[laughter]—we have a great team at State that was there long before I got there. But we have priorities. Our No. 1 priority is building a global financial platform and integrating six legacy data bases into one legacy data base and building that across 171 different countries and 150 different currencies. That's our premier goal, building a global financial management system.

Getting an independent audit of our internal controls is something we certainly want to do, certainly want to work toward, whether or not in a scarce resource environment like the one we're heading toward, and with the responsibility that you and other members of this committee and Congress hold to get the deficit cut in half for the next few years and then eliminated.

If we can do all of this, these are certainly things we want to do. So that's certainly the direction we're trying to head.

Mr. PLATTS. With all due respect, I know at least one or more of your fellow witnesses here are military veterans as well. I think that's the can-do attitude of the Marine in you coming out, that we're just going to get it done. And that's a good thing.

I think the point you just made about the scarce resource environment in which we're in is all the more why making sure we get it right on internal controls needs to be a priority. We talked last week with the Comptroller General about the $45 billion, OMB's estimate, best possible, which doesn't include all departments and agencies, of the improper payments. As we get ready in January 2006 to begin the new Medicare prescription drug plan that is going to cost somewhere in the $50 billion or $60 billion a year range, we can fix our internal controls, especially at DOD and some of the larger agencies, Medicare itself. It goes a long way to paying that commitment on prescription drugs without new money, but just with the money we have, but better accounting and use of it.

So even in scarce resources, I know it's going to be challenging to come up with these dollars for the additional cost. But it's all

the more why we need to do it. But your message is still well heard. I have said many times, I'm not an appropriator. All of us wish we were. If I could wear my oversight hat and my appropriation hat, it would be a perfect match, although that would not be a good internal control probably. [Laughter.]

So I need somebody watching me.

I want to actually take up where I got off track here. With FMFIA, from the management attestation requirement there, is that in your opinion, both from the Department and GAO, fulfill the new Circular requirement of attestation on your internal controls, if you do go through what's required under FMFIA?

Mr. STEINHOFF. Yes.

Mr. PLATTS. So is there a belief that we need to do anything from a statutory standpoint with the act itself to strengthen it, to kind of dovetail with what OMB has done through the administrative process?

Mr. STEINHOFF. No, because the act envisioned that OMB would issue the guidance and would lay out how to assess and report.

Mr. PLATTS. So to maintain that discretion?

Mr. STEINHOFF. Yes.

Mr. PLATTS. OK. I'm always an optimist, that when we lay out our plans we are going to move forward and achieve them and strive to our best ability to do so. But given that 20 year history, Mr. Steinhoff, you have recounted it well in your testimony, both written and here today, of FMFIA from 1982 through the 1980's and mid-1990's and basically kind of like, it's not working. Well intended, but we didn't get the results.

Why would you believe that we should be more optimistic this time, that we are really going to get it right and do what we're all setting out to do, and wy shouldn't we be? Is there a reason we should not be optimistic?

Mr. HIGGINS. I think 20 years ago there was a lack of appreciation for the importance of internal control. Since that time, there has been a lot of emphasis given to financial reporting, financial statement audits. There is a better understanding of the need for that. Plus, we have had some terrible situations in the private sector that brings it to everybody's mind.

I think the revisions to the new A–123 would do a lot. It lays out management's responsibility, it gives specific guidance into what they should do for the financial statement part of the reporting. So I think that we should wait and see.

Mr. PLATTS. Kind of the silver lining in some of the bad occurrences of ENRON and WorldCom is that it's raised the level of scrutiny and the priority of this issue?

Mr. HIGGINS. Absolutely. I mean, in my department alone, there has been a tremendous amount of improvement in the last 4 or 5 years. The Student Financial Aid Office just got taken off the high risk list.

Mr. STEINHOFF. And I think in looking at it, there were some very positive by-products of FMFIA in the early years. It did drive internal control down to the lowest level. There were literally thousands and thousands of small control tweaks at those lower levels. And agencies did a lot, some maintained it, some perhaps did not. But they did a lot to document their underlying systems. There has

been a lot done with the passage of the CFO Act to document the underlying accounting systems and those operations, which really is a great jump start to revitalize FMFIA.

So I think in some respects, as I mentioned before, we are ahead of the private sector going in. We have some tremendous challenges. We have a different level of accountability, and our accountability is much more visual to the average person when they don't get their benefit check or the Government does something wrong. But I think there is that appreciation. I also believe you have a different type of manager in Government today and you have a set of, a cadre of highly qualified CFOs, which you did not have back in 1982. That was kind of an afterthought that was added to someone's title, and they really didn't focus on internal control.

Mr. PLATTS. I share that belief as well, in the CFO Act. It's one of the reasons we pushed for Senate confirmation of the DHS CFO, was to ensure we didn't regress. We have established a high standard for our CFOs, and to ensure that scrutiny does occur, because we do want that mind set that's changed to continue and not go the other way.

Mr. WOLFF. Sir, I fully concur with what my colleagues have said. Certainly the financial environment today is substantially different in many ways from the way it was back in the 1980's. I was around back in those days, too. It is a totally different way of doing things. There is far more emphasis on doing things the way the private sector does them and lifting best practices from the private sector and applying them appropriately in Government.

But probably more important than that is, for reasons I'm not quite certain I understand, the folks that are doing all the hard work on this internal controls review and documentation are seeing the value of doing it. So you are institutionalizing something that is essential to begin with. I think that is going to be the key to the success of this, that people are actually seeing the benefit of what they are doing.

Mr. PLATTS. I think when I caught my breath I remembered the question I wanted to followup with when we were talking about the cost of doing it. This kind of relates to Secretary Wolff, the value of doing it.

Now at State, Secretary Burnham, you're looking at, say, $4.5 million extra to get your Department in place to do the internal audit and move forward from there, which is going to be out of, in essence, your portion of State's money that you are given. Is there any discussions, dialog at the senior level in State, or Commerce or Education, that there is an incentive to do it? I'll give you an example, with Homeland Security. Last year, as we were pushing for my legislation, there was a report about within the Transportation Security Administration, I forget how many tens of millions of dollars of overruns regarding, I think it was screening equipment or something, because of lack of good internal controls.

So even if they had spent $10 million in making sure their internal controls were up to par, they would have come out way ahead as a Department whole. But to the IG or financial management sector of DHS, they spent more money. In other words, if by doing this audit you are able to identify savings that those savings accrue

to your office within the Department to help pay for the cost, are there any discussions of that nature?

Mr. BURNHAM. We do have discussions of that nature, although I think long term, the State Department is going to get savings from other areas, such as the 21st century technology platform, such as fulfilling the President's vision of competitive sourcing, the PMA agenda item on competitive sourcing. I think this is going to be far more beneficial to the State Department and to the American taxpayer, at least in our case.

And as of now, I would certainly say we are going to have to find the money to get us to a level of testing and documentation. Although I would not say that the goal of getting to a place where we can receive and be comfortable that we are going to receive a clean opinion on an independent audit of our internal controls is anything different from what we had planned to do before Circular A–123 Appendix A. In other words, I think that, as my colleagues today have outlined, it's a new environment than it was 20 years ago. It's a new environment than it was 4 years ago. And reflecting that, we have changed our focus and are trying to grow with it.

Mr. PLATTS. And with the suggestion in my question about sharing of the benefits, there is a little bit of caution there, because there would be a little bit of a gotcha, if one part of State finds wrongdoing by another part, you get the benefit of that savings, which could create some internal battles or tension. But it's something that when we are looking to how to pay for this renewed effort, there are going to be benefits reaped.

The example my staff shared with me in my memory is, the total contract was $18 million, and the question here of which $9 million was not able to be accounted for by the Department. And originally it was only a $4 million score to begin with. So it escalated dramatically and then couldn't be accounted for in the end, half of what that escalation was. So obviously it would have been a Department-wide benefit to having better controls in place. So something to perhaps look at as you are looking for money. Because you rightfully acknowledge it's going to be hard getting additional dollars from Congress, given the fiscal challenges we are facing as a Nation.

Mr. BURNHAM. Mr. Chairman, I believe you are referring to the Iraqi money, not the IRRF money.

Mr. PLATTS. This is in TSA here, stateside.

Mr. BURNHAM. OK.

Mr. PLATTS. Yes, not within State, but within Homeland Security.

Mr. HIGGINS. From the IG's perspective, the community certainly thinks this is like apple pie. But the highest people in the Department of Education clearly recognize that we bring back through our recommendations and work more than we cost the Government. But these unfunded mandates are killing us. In my office alone, in 1996, we were at 368 people. Today we are at 285. That's almost an 80 person FTE reduction because of the cost of the financial statement audit, and the cost of doing business. So we're getting fewer people and more responsibility. So it is a concern of the IG community.

Mr. PLATTS. As we demand more, we give you less.

Mr. HIGGINS. Well, you actually give us more, but it doesn't cover the bill. It's sort of like my home budget. [Laughter.]

Mr. WOLFF. May I comment, Mr. Chairman?

Mr. PLATTS. Yes, Secretary Wolff.

Mr. WOLFF. I would just like to make sure that my record is clear here. I strongly support this review. We are eating internally in each of our bureaus the costs of doing the reviews and the documentation. My concern is that the annual audit opinions are going to increase costs considerably. That's quite different from doing the work that we are doing under A–123. We are going to be doing the work, and monitoring the progress. The IG is going to be watching what we are doing as are GAO and your committee and a host of other folks.

It's rendering the audit opinion by one of the big four where we run the risk of giving them a blank check, quite frankly.

Mr. PLATTS. Point well made. It is something that we need to be smart about how we do this and not create a new problem as we try to fix an old one.

Mr. STEINHOFF. Mr. Chairman, I would say that I agree that the process has to be well managed and expectations should be well managed. It has to be done in a very smart manner. That's why we see some kind of phased approach to opinions on internal control, when it makes sense for an agency.

I want to add another perspective on control which I think benefits from really exploring one's controls. In some areas, frankly, there's too much control. I'll give you an example. We did a review a few years ago where we benchmarked what were the travel policies for best practice companies. And they would have anywhere from 8 to 15 pages of rules. They would enforce those rules. If you broke the rule, you were no longer employed there.

We compared that to DOD; we worked with DOD on this in a collaborative effort. They had 1,357 pages of travel rules at that time. They were accounting for every nickel and dime. They had to have people there to help people fill out the vouchers. And they went through a major process to streamline and knock out pages and pages of rules. There were unnecessary controls. Probably every time something went wrong over 50 years, they added another requirement. They went through and they just simplified it. They got some legislation and no longer do you have to have a cab receipt for $5. You have to trust the person if it's less than $75.00, and just change the whole accountability approach.

We did another review where we found horrendous controls over property, but at the same time, we found millions of accounting transactions that Defense was processing, thinking they were providing more accountability. Those accounting transactions actually were dropping the items from visibility. So there was a tremendous expense to process all those transactions. And those transactions were worsening control.

So when someone gets down there and starts kicking the tires, and gets down there in the weeds, I think they will find as a byproduct there are ways to streamline and simplify. Agencies should be allowed to look at things in a cost beneficial manner, not spend $1.10 to save $1.

Mr. PLATTS. That's something that, this committee, we share that perspective, with those 1,357 pages of travel rules, they probably had about 100 different systems to monitor compliance with them, too, given the number of systems over there at DOD.

Mr. STEINHOFF. Yes.

Mr. PLATTS. But that point is something that, will be something we are going to pursue as a committee on the financial management laws, is that we have added over the last 20 plus years numerous laws. And part of our efforts, we have stated as a subcommittee this session, is to try to streamline all those laws to make them more efficient, that you can comply, as our Federal financial managers out there, a little easier on the financial management community to know that you are in full compliance with what Congress is expecting of you.

So as we said last week, and will say again today, we will be looking for great insights from CFO Council, from the PCIE, from GAO as we move forward in that streamlining process.

I want to just maybe touch on one last issue here from the auditing process. Inspector General Higgins, we had your colleague, the CFO at Education, here last week, we talked about the continuous auditing process, and how, because of Sarbanes-Oxley and the private sector more of a year-round engagement rather than end of the year run, or sprint, I would be interested in each of your Department's perspective. My understanding is at Education that is kind of more the norm, where you are starting in February or so, leading up to the end of the year, rather than waiting for the last couple of months.

Where is Commerce, State? I want to make sure I'm accurate with Education. And then Jeff, from a broad perspective, your familiarity with others. What is the norm out there now and is this a good idea that we see in the private sector, that it is more a year-round process, hand in hand with your auditors?

Mr. WOLFF. We are getting close to having a year-round auditor presence. They left in December and they are going to be back next week for their in-brief for the current fiscal year. I think it's beneficial. I think it's beneficial to have them there, quite frankly. The earlier they start, the easier it is to get all the problems that they may encounter out of the way by the end of the year.

So that's where we are, and I anticipate that we will be eventually getting them regular office space.

Mr. BURNHAM. Similar to State, thanks to the leadership of OMB that required quarterly statements, of course. We now are around the clock, around the year producing the kinds of financials that are necessary to achieve OMB's requirement. By the way, that's also part of the PMA. So just getting to green in fulfilling the President's vision is also part of that.

Our own audit started last month. We will continue to press on to November 15th of this calendar year.

Mr. PLATTS. OK. Thank you.

Mr. HIGGINS. You are correct about Education. I do think it is a benefit. I mean, as issues come up during the year, they are there and they know about them in advance. So they are able to give more information while it is going on. I think it is a benefit.

Mr. STEINHOFF. I think it is the norm for large entities. These are large entities, when you talk about the CFO Act agencies. That's the norm. It's got benefits on both sides. This is a real key to audit quality. This morning I participated in a forum that the Public Company Accounting Oversight Board held where there was lots of talk that the key to a good audit of a private sector corporation, publicly traded company, is the auditor's knowledge of the business. If you're auditing Proctor and Gamble, you have to understand the business. You have to understand their competitors. You have to be looking at things in that context and have a complete understanding of the business and how they operate.

To successfully audit these large Federal entities, you have to have an understanding of the Federal Government, of the Federal environment and of the missions and programs and operations of that Department. So having auditors there full time year-round, is very beneficial to the auditor. For the financial audits that we conduct, we are there year-round. We never leave IRS. That's a huge, complex operation. We are there 12 months a year.

Also, we work very hard to have continuity on that audit. We don't put a new bunch of people on every year, when we rotate someone off, we bring them along and we have experienced people doing that work. They have to understand those processes, how those systems work over there, the complexity of the tax systems. Year-round is the only way to go. Small entity, that's a different story. You can come in and out.

Mr. PLATTS. The fact that we are more and more the norm being year-round I think is another reflection of that change in mind set and focus on these issues. I have had the benefit, as a new subcommittee chairman, last term, coming in following Steve Horn, who really took his responsibilities very seriously for this subcommittee's oversight role and focusing on financial management. And I came into the Congress in 2000 with a President who has made good management a cornerstone of his administration through the President's management agenda, which I'm trying to help keep pushing the ball in the right direction down the field as a newer chairman.

One last thing, and for our two CFOs, kind of a little bit off the issue of internal controls. But it's just a structural question, and I think Secretary Burnham, you mentioned earlier internally your work with CFOs of different offices, programs within the Department that you work with that are specific to one part of the Department. I was curious, within both your Departments structurally your oversight of those subordinate CFOs from a hiring review standpoint relates to another agency we are looking at and how you in the end are the one who is going to be responsible for the entire Department's information. But what really direct interaction do you have or oversight do you have of those subordinate CFOs?

Mr. WOLFF. Yes, sir, I can't speak for Secretary Burnham, but I will say that at the Commerce Department, I personally interview each major bureau CFO before he or she is hired. My statutory deputy CFO also interviews them. My statutory deputy, Jim Taylor, who is sitting behind me here, also has 25 percent of their per-

formance evaluations each performance cycle, in consultation with me.

Mr. PLATTS. Great.

Mr. BURNHAM. I believe it was Secretary Wolff who mentioned that he had the CFOs in other parts of the Department of Commerce. We don't have CFOs, actually, elsewhere. I have a deputy CFO. But what we do have is financial management officers at our posts overseas. These are incredible men and women, the quality of these individuals, many of them certified public accountants that are now coming in, many of them in second careers that have come in from the private sector who want to join the Department, who want to go overseas and are fulfilling the role of Chief Financial Officer of an embassy. Some of these embassies are absolutely enormous. In Cairo, we have over 3,000 individuals, in Berlin, certainly Baghdad is also going to be quite large.

So just because we don't call them a CFO does not mean that they are not. It is that individual embassy's assurance statement that Ambassador must submit to my office annually. That is the backbone of the Secretary's assurance statement and part of our overall review and existing internal control process, leading of course not only to mine, to the Secretary, but ultimately to the Secretary as reported in the Performance and Accountability report.

Mr. PLATTS. You don't have the same direct interaction on the interview process and review, given the number of posts out there, it sounds, as at Commerce?

Mr. BURNHAM. Because of the uniqueness of the State Department, they are Foreign Service officers, thus they go through the hiring process of the Foreign Service. Then they do not report to me, they report to the Ambassador, who is the chief executive officer, and as we know, the chief American in country, except when the President visits.

Mr. PLATTS. OK. Inspector General Higgins, are you familiar with that structural oversight within Education? I didn't think to ask Mr. Martin last week.

Mr. HIGGINS. Actually, he was just here a little while ago. Jack reports directly to the Under Secretary or Deputy Secretary in the Department. I think that's the appropriate line of reporting.

Mr. PLATTS. As far as other subordinate CFOs, you're not sure what——

Mr. HIGGINS. There are no other—well, there is a CFO at FSA—the PBO, at the Department of Education—but she reports to the COO of FSA. But there is a reporting relationship down at the CFO level to Jack's office. It's not real clear, actually.

Mr. PLATTS. OK. Something I think that as we look at promoting greater internal controls, including in the management standpoint, because ultimately as we say, at Commerce you are responsible for those final or overall department financial management and having input, reviews and hiring input to who is running those operations at the subordinate level is, I think, very important.

Mr. WOLFF. Yes, sir. I just want to make sure I clarify, my colleague mentioned the PBO over there. We also have a PBO, which is the Patent and Trademark Office. I do not have 25 percent of their performance evaluation, nor do I interview their selectees for their financial positions over there, by law.

Mr. PLATTS. OK. Thank you.

I think we touched on the issues we wanted to cover. I want to thank you again for your patience with me running in and out. As we go forward, we touched on two very important issues that both the Council and the President's PCIE and CFO Council are going to play a role in that implementation of the new Circular and in that cost benefit, that joint study. We will look forward, as a subcommittee, working with all of you on that, as well as with GAO on this issue.

I want to commend each of you for your efforts. I said as we had a staff briefing in anticipation of today's hearing, one of the things, in reading your bios and your experience and the successor efforts at your respective departments or at GAO is, we want you to kind of finish that 2 or 3 year focus at State, do your work, and then we want to move you en masse over to DOD. [Laughter.]

We're going to put you to the next challenge. Because that certainly is, as we heard last week, ultimately for the Federal Government as a whole, we can do great work, but eventually we have to take on that 600 pound gorilla that's sitting out there. You are getting great experience and doing great work that we want to at some point have benefit that Department as well.

So thank you for your testimony and your time today. We will keep the record open for 2 weeks for any additional information and submissions that you may have. This hearing stands adjourned.

[Whereupon, the subcommittee was adjourned.]