SECTION 2
CHAPTER 2
PLAN AND SCOPE OF THE EVALUATION

The key organizing and planning steps are:

- Establish the process
- Significant financial reports
- Materiality thresholds
- Significant accounts
- Relevant financial report assertions
- Major transaction cycles
- Link accounts and transaction cycles
- Establish overall organizational approach

ESTABLISH THE PROCESS

There is a difference between the overall Federal Managers' Financial Integrity Act of 1982 (FMFIA) assurance statement that the Department has been issuing since 1983 and will continue to issue and the assessment of internal controls for financial reporting required by the 2004 revision to OMB Circular A-123. The overall FMFIA assurance statement addresses the three overall objectives of internal control: effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The assurance statement on internal control is a subset of the existing FMFIA assurance statement. It requires management to specifically document the process and methodology used to evaluate the operating effectiveness of internal control.

Determine the Overall Approach: A Top-Down Focus. Under A-123, the support for management's assurance statement should not begin in independent review areas that eventually work their way up the chain of command. Instead, the Department will meet the strengthened monitoring requirements through a top-down approach focusing on the assurance at the Departmentwide level. This approach begins with the Department's significant consolidated financial reports and works back to the key processes, controls, and supporting documentation. This approach also focuses resources on the items most material and most at risk to the Department's financial reporting.

Organizational Structure. DOI has established an integrated organizational structure to implement the Internal Control Program. This structure starts with the Secretary descends to the program assistant secretary, to the bureau director, and finally to the program manager. Roles and responsibilities of key components of the Internal Control Program are described below.

Roles and Responsibilities.

<u>Senior Management Council (SMC)</u> - within DOI, the responsibilities of the Senior Management Council are implemented by the DOI Internal Control and Audit Follow-up Council which is chaired by the Assistant Secretary-Policy, Management and Budget and is comprised of all program assistant secretaries, the Solicitor, the Inspector General (ex officio), Deputy Assistant Secretary for Business Management and Wildland Fire, the Chief Information Officer, and Senior Procurement Executive. The Council provides senior-level oversight of the Internal

Control and Audit Follow-Up programs, resolves issues related to both programs, and decides reporting issues for the Department's Annual Performance and Accountability Report (PAR). Specifically, the council will:

- Ensure DOI's commitment to an appropriate internal control environment;
- Approve DOI's implementation plan for assessing and reporting on internal controls over financial reporting;
- Assess and monitor correction of deficiencies in internal control;
- Identify and ensure correction of systemic weaknesses;
- Review and approve management's annual assertion on effectiveness of internal controls over financial reporting;
- Recommend to the Assistant Secretary-Policy, Management and Budget which control deficiencies are material to disclose in the annual FMFIA assurance statement and PAR;
- Oversee implementation of corrective actions related to material weaknesses; and
- Determine when sufficient action has been taken to declare a reportable condition or material weakness corrected.

<u>Senior Assessment Team (SAT)</u> – The duties of the Senior Assessment Team as defined in Circular A-123 are assigned to the DOI Management Initiatives Team (MIT) which is chaired by the Assistant Secretary Policy, Management and Budget and comprised primarily of Deputy Assistant Secretaries and Bureau Deputy Directors. Duties of the MIT in implementing the Circular are to:

- Ensure assessment objectives are clearly communicated throughout Interior;
- Ensure adequate funding and resources are made available to comply with the new requirements of the revised Circular;
- Ensure assessments are planned, conducted, documented and reported upon in a thorough, effective, and timely manner;
- Identify staff and/or secure contractors to perform assessments;
- Determine the scope of assessments and materiality thresholds in accordance with the requirements of the revised Circular; and
- Determine or approve assessment design and methodology for each entity and the Department.

<u>Office of Financial Management (PFM)</u> is responsible for: (a) Providing staff assistance to the AS/PMB and the Senior Management Council; (b) Recommending internal control policies and procedures; (c) Providing oversight and guidance to the bureaus/offices concerning the review, evaluation, and maintenance of effective controls; (d) managing, directing, and evaluating the Department's reporting under OMB Circulars A-123 and A-127, the FMFIA, the Federal Financial Management Improvement Act (FFMIA), and the Chief Financial Officers Act, as amended (CFO Act). PFM annually issues *Guidelines for Internal Control and Audit Follow-up Programs* providing that year's schedule of key actions.

<u>DOI Assessment Teams</u> – composed of bureau staff from each bureau assigned to test other bureau key controls and provide independent review. PFM is the project manager.

Provide training. Training should be developed and tailored to the level and type of involvement expected from participants in the process. Management, process owners, and those carrying out transaction cycles will need training applicable to their area of responsibility.

Appropriate training should be given to personnel whether involved in planning at a high level, preparing documentation, or testing controls.

Development of standard templates for documentation. Use standard templates, workpapers, and forms for documentation of all processes, testing, and conclusions to expedite the review and allow comparability of findings across the Department.

Document the Plan and Methodology for the assessment. The assessment of internal control over financial reporting should be documented as follows. This documentation should be readily available for review and should include appropriate representations from officials and personnel responsible for monitoring, improving, and assessing internal control.[1]

- The establishment of the senior assessment team, its authority and members
- Contracting actions if contractors are used to perform or assist in the assessment
- Communications with Interior's management and employees regarding the assessment
- Key decisions of the SAT
- The assessment methodology and guide, including:
    - The understanding obtained and the evaluation of the design of each component of the entity's internal control over financial reporting
    - The process used to determine significant accounts and disclosures and major classes of transactions, including determination of the locations or agency components at which testing was performed
    - The process and decisions supporting a test plan which forms the approach for evaluating all controls and possible contingencies for completing testing related to internal control over financial reporting (e.g., rotational testing schedule)
    - The reliance on the work of others, such as for cross-servicing entities or service organizations, and how the sufficiency of such work was determined
    - Other information that could affect management's certification of its internal control over financial reporting
- The assessment of internal control at the entity level (Refer to Addendum D)
- The assessment of internal control at the process, transaction, or application level (Refer to Exhibit 2 and Exhibit 3)
- The testing of controls and related results
- Identified deficiencies and their classifications
- The remediation plans and actions taken to correct identified deficiencies

Establish a process to communicate and coordinate with the OIG. The OIG is responsible for the audit of the Department's financial statements. Even if the OIG and any hired CPA firm are not performing an audit of Interior's internal control assessment, the OIG and the CPA firm are still required to evaluate and report on Interior's compliance with laws and regulations that include compliance with Circular A-123 and FMFIA. The auditor may rely in part on management's testing of internal control over financial reporting, so obtaining and incorporating the OIG and CPA firm's views of management's assessment plan provides the opportunity to design the evaluation in a way that enables the auditor to conduct a more efficient audit. In that same vein, it is prudent to integrate other control-related activities and determine internal assessments that may impact control objectives related to financial reporting.

[1] Circular A-123, Appendix A, Section IV.B.

Though not a requirement, Interior's management may ask the auditor to provide an audit opinion on internal control over financial reporting. In that case, the auditor should be involved in key aspects of the process, starting in the planning phase. Also, access to the project calendar allows the auditor to maximize the efficiency of interviews and testing processes by attending those significant to their opinion. If Interior's management elects to receive such an audit opinion, Interior may adjust the "as of" reporting date of June 30 to coincide with the "as of" date of the audit opinion.[2]

Establish standards for contract support personnel. Ensure that any contractors used to perform any aspect of the assessment, such as preparing the assessment plan, documentation, or performing testing have the appropriate qualifications. It is best for such contracts to clearly define the scope of performance so the contractor's work may be reviewed before it is included in management's final assessment.

Establish a basis to communicate, review, remedy, and obtain management concurrence. Management is responsible for documenting the internal control over financial reporting even if documentation has been prepared by the senior assessment team or others. Establish a process for management to review and comment on the documentation, those conducting assessments to respond to management's comments, and management to indicate its final decision on the effectiveness of internal control over financial reporting based on the evidence. The senior assessment team should retain evidence of the review and approvals through signatures or electronic postings.

Prepare a calendar. Interviews and meetings with Department and bureau management and personnel should be scheduled as early as is feasible and then posted to a calendar that is maintained and accessible. This allows process owners adequate time to plan the interviews and meetings, and it enables delays in the assessment to be identified and corrected before affecting deadlines. Testing of monthly and quarterly financial reporting should be scheduled throughout the year to balance workloads. Refer to the memo *Guidelines for Internal Control and Audit Follow-up Programs* issued annually by PFM for a schedule of key actions.

Establish a status reporting process. Status reports identify the status of all tasks relating to the assessment's critical paths, and ensure those affected by the assessment are kept informed of the assessment's progress, the upcoming steps, and any issues that need to be resolved. Status reports should be scheduled and issued on a regular basis which is posted in the calendar.

SIGNIFICANT FINANCIAL REPORTS

The Department has identified the following principal financial reports as "significant" and subject to Circular requirements[3]:

1. Annual/Quarterly Financial Statements
2. Year-end Financial Statement information supporting the Financial Report of the U.S. Government
3. SF-133, Report on Budget Execution and Budgetary Resources
4. SF-132, Apportionment and Reapportionment Schedule
5. SF-224, Statement of Transactions

[2] Circular A-123, Appendix A, Section V.A.
[3] Circular A-123, Appendix A, Section II.B.

6. FMS Form 2108, Year-End Closing Statement

Other reports may be subject to the Circular requirements based on qualitative and other criteria.

MATERIALITY THRESHOLDS

The Department should set materiality sufficiently low for the assessments to ensure that controls are in place to prevent and detect material internal control weaknesses, with goals to ensure timely, current, accurate, and accessible financial information. As defined in Financial Accounting Standards Board (FASB) Statement of Financial Concepts No. 2, materiality represents the magnitude of an omission or misstatement of an item in a financial report that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item. Materiality is based on the concept that items of little importance, which do not affect the judgment or conduct of a reasonable user, do not require investigation. Materiality has both quantitative and qualitative aspects. Even though quantitatively immaterial, certain types of misstatements could have a material impact on or warrant disclosure in the financial statements for qualitative reasons.

Planning Materiality. The Department should estimate materiality as defined above in relation to the element of the financial statements that is most significant to the primary users of the statements. Although a computation may determine planning materiality, judgment is needed to evaluate whether the computed level should be adjusted for such items as unrecorded liabilities, contingencies, and other items that are not incorporated in the financial statements (and not reflected in the materiality base) but that may be important to the financial statement user. The planning materiality threshold for the set of financial statements and the thresholds for other reports are considered when determining extent of testing. Materiality and therefore extent of work may differ from report to report ensuring that items required to be reported will be detected.[4] Materiality should be reconsidered at least immediately prior to concluding on the assessment and determining what control weaknesses must be reported.[5] Refer to Addendum A for discussion on financial reporting items not covered by the financial statement materiality definition.

Interior's planning materiality for financial statement line items, based on net cost to the government (appropriations), is specified as 1% of Net Outlays for the prior fiscal year's Combined Statement of Budgetary Resources (the materiality base).

Testing Materiality. Interior's testing materiality is the same as planning materiality. Reviewers will assess material items. Management's materiality is well below the financial statement auditor's materiality defined by GAO as 1% of the larger of Assets or Expenditures.

Report Materiality. Report materiality is a function of management judgment, and it serves as a threshold of reporting control weakness as reportable or material, impacting whether an unqualified statement of assurance can be issued. In the reporting phase, the Department considers whether misstatements are quantitatively or qualitatively material. If considered to be

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[4] Revised Circular A-123, Appendix A, Section II.C.

[5] Page 17 in CFO Council's *Implementation Guide for OMB Circular A-123, Management's Responsibility for Internal Control, Appendix A*

material, the Department is precluded from issuing an unqualified statement of assurance over financial reporting. Report materiality generally should be 3% of the materiality base.

SIGNIFICANT ACCOUNTS

For each applicable financial report, apply the materiality threshold to identify accounts or groups of accounts that may have a material effect on the respective financial report. Consider whether there is more than a remote likelihood that the account may contain misstatements (either an overstatement or understatement) that individually or in the aggregate may have a material effect on the financial report. Then, identify significant transactions that affect those accounts. Refer to Exhibit 1 for an example Internal Control Matrix with significant accounts.

Qualitative characteristics to consider include:

- Political sensitivity of a program or balance
- Importance of a balance or amount to oversight agencies and their reliance on such balance or amount
- Knowledge of past errors
- Susceptibility to loss due to errors or fraud (e.g., intentional manipulation of estimates used in the financial reports or material misappropriation of assets)
- Accounting and reporting complexities associated with the account (e.g., environmental liabilities, actuarial liabilities)
- Likelihood of significant contingent liabilities arising from the underlying activities
- Changes in account characteristics.

RELEVANT FINANCIAL REPORT ASSERTIONS

Map the financial report assertions to each of the significant accounts. Not all assertions will be relevant or significant to all accounts. The following are the types of assertions that may be inherent in the significant accounts[6]:

1. <u>Existence and Occurrence</u> – All reported transactions actually occurred during the reporting period and all assets and liabilities exist as of the report date.
2. <u>Completeness</u> – All assets, liabilities, and transactions that should be reported have been included, and no unauthorized transactions or balances are included.
3. <u>Rights of Ownership and Obligations</u> – The Department legally owns all assets, and all liabilities are its legal obligation.
4. <u>Valuation and Allocation</u> – All assets and liabilities have been properly valued and where applicable, all costs properly allocated.
5. <u>Presentation and Disclosure</u> – The financial report is presented in proper form with required disclosures.
6. <u>Compliance</u> – The transactions are in compliance with applicable laws and regulations.
7. <u>Safeguarding</u> – All assets have been safeguarded against fraud and abuse.
8. <u>Documentation</u> – Documentation for internal control, all transactions, and other significant events is readily available for examination.

Risks are associated with each type of assertion, so the team should review each significant account and determine the type of material error or misstatement that may occur for each assertion. This step is critical. The results of the evaluation of these assertions and identification

[6] Circular A-123, Appendix A, Section II.A.

of risks will help determine the types of controls that should be assessed and the tests that will likely need to be performed during the Document Controls and the Evaluate Design and Operating Effectiveness phases.

MAJOR TRANSACTION CYCLES

Identify the major transaction cycles or classes of transactions that materially affect each of the significant accounts or groups of accounts. A major transaction cycle is a business process for which the quantity and dollar volume of transactions is so great that if a material error occurred in the process, it would affect the Department or bureau's decision-making process. For example, disbursement of funds is a major transaction cycle since a material error may affect several accounts, including Fund Balance with Treasury. Another consideration when identifying major transaction cycles and financial systems is whether the transactions are routine, non-routine, or represent an accounting estimate. Refer to Attachment 2 for transaction cycles that should be considered for testing.

LINK ACCOUNTS AND TRANSACTION CYCLES

Use mapping and link significant accounts to the transaction cycles and processes that provide the source data. List all significant accounts and ensure that each has the requisite transaction cycle(s) mapped to it.

ESTABLISH OVERALL ORGANIZATIONAL APPROACH

Interior is using a Departmentwide approach whereby analysis of the Departmentwide financial statements and identification of the significant line items helps determine which components, programs, or administrative functions contribute to those line items. Only those controls needed to provide sufficient evidence to provide assurance on the internal control over the Department's financial reporting are evaluated. This process will be repeated for all significant reports and all material line items included in the Department's assessment.