

CHAPTER 3. EVALUATING MANAGEMENT CONTROLS

- 3-1. **Purpose.** This chapter defines the management control evaluation process. Evaluations of a program, system, accounting function, or administrative activity are performed to determine whether adequate control techniques exist, and identify material and other weaknesses in management controls.
- 3-2. **Policy.**
- A. All levels of management are responsible for ensuring the adequacy of controls. Managers must plan and conduct ongoing evaluations of management controls to:
 - 1. Ensure that the controls remain effective and efficient, and function as intended; and
 - 2. Identify management controls that need to be strengthened or streamlined.
 - B. As required by the FMFIA the evaluations of management control systems must be conducted in accordance with standards established by GAO in their Standards for Internal Control in the Federal Government. These standards define the minimum level of quality acceptable for management control systems in operation and constitute the criteria against which systems are to be evaluated.
- 3-3. **Types of Management Control Evaluations.** While management control evaluations can take many forms, the two basic types, are:
- A. Management Control Reviews (MCRs). Detailed evaluations of the complete system of management controls in a functional area. Such a review will produce extensive documentation of controls and will include the testing of most, if not all, controls.
 - B. Alternative Management Control Reviews (AMCRs). Evaluations of the control techniques in a functional area using a more limited scope methodology than the MCR. Examples include OMB Circular A-130 computer security reviews, OMB Circular A-127 financial system reviews, management reviews, and OIG and GAO audits. Each evaluation must adequately cover the functional area, produce sufficient written material, clearly documenting procedures followed and findings noted.
- 3-4. **MCR Requirements.** A MCR is a comprehensive and detailed review of operations in a functional area. It includes:
- A. Identification of the event cycles. An event cycle is a process used to initiate and perform related activities, create the necessary documentation, and gather and report related data. Each program, administrative, and accounting function contains one or more event cycles. These cycles provide the focal points for the conduct of management control reviews.
 - B. Analyses of the general control environment. The general control environment in which a cycle operates has a major impact on the effectiveness of controls. The control environment analysis performed during the annual risk rating for the FMFIA

process can be referred to and updated to meet the requirements of the management control review analysis.

- C. Documentation of the event cycle. The reviewer should document the event cycle to obtain a thorough understanding of how it operates. Examples of documentation include the procedures, responsible personnel, and the forms and records developed and maintained as part of the cycle.
- D. Evaluation of the management controls within the event cycle. During this step, the cycle control objectives and techniques are identified and their documentation is reviewed to determine whether the system will provide reasonable assurance that the objectives of management control, as specified in FMFIA, are met. If they are met, the potential for waste, loss, unauthorized use, or misappropriation is significantly decreased.
- E. Testing of management controls. This final step in the actual review of management controls is testing the control techniques to determine if they are functioning as intended. Existing controls are tested by selecting a sample of transactions, reviewing the documentation, asking questions, and making other observations and inquiries to determine if the controls are functioning as intended.
- F. Reporting the results. The report is presented to the manager(s) of the functional area(s) reviewed and is used to initiate corrective action.

3-5. **AMCR Requirements.** OMB Circular A-123 encourages agencies to use alternatives to the MCR process. Existing management reviews and reports, including reviews made under OMB Circular A-76, Performance of Commercial Activities, A-127, and A-130, questionnaires, checklists, and other management reviews and studies, may qualify as an alternative. These alternative reviews must determine overall compliance and include testing of controls.

At a minimum, AMCRs must include the following steps:

- A. Identification of activities included in the functional area;
- B. Identification of high risk activities;
- C. Identification of key controls in high risk activities;
- D. Identification of control techniques;
- E. Limited testing of key control techniques to determine that objectives are being met; and
- F. Reporting on the results.

3-6. **Documentation and Testing.** The following requirements must be met by both MCRs and AMCRs.

- A. Review Documentation.

1. The reviews of management control systems are to be clearly documented and the documentation is to be readily available for examination. The scope of the documentation should allow an independent reviewer, with general knowledge of the systems under study to understand the process and the conclusions reached.
 2. Review documentation should show the type and scope of the review, the responsible official, key findings, recommended corrective action, and other pertinent data. It should either use the existing system documentation, if current and complete, or provide the missing or incomplete documentation needed to understand the system's current operations.
 3. MCCs are responsible for assuring that the documentation is organized, formatted and available for review. Government Technical Representatives (GTRs) and Government Technical Monitors (GTMs) are responsible for performing these functions when MCRs and AMCRs are performed by contractors.
- B. System Documentation. System documentation should sufficiently cover the policies and procedures, organizational charts, manuals, memorandums, flow charts, and related written material necessary to describe organization structure, operating procedures, and administrative practices. It should also identify responsibilities and authorities for accomplishing programs and activities.
- C. Testing. The testing of controls as part of an MCR or AMCR must:
1. Identify the controls to be tested;
 2. Select methods for testing;
 3. Determine the scope of testing;
 4. Select organizations/locations to be tested;
 5. Conduct the tests;
 6. Document and analyze the tests; and
 7. Report the test results.
- D. Testing Documentation. Each step in the testing process must be fully and clearly documented.
- 3-7. **Reporting on Results.** Reports must describe management control weaknesses which need to be strengthened. Those weaknesses considered to be material (see Exhibit 3-1) must be separately identified from those weaknesses which are not material. Material weaknesses identified must be clearly related to specific deficiencies in management controls and should be quantified wherever possible. Recommendations to reduce or eliminate control weaknesses should be reasonable and cost-effective.

3-8. **Early Warning Reporting.** A mission-critical problem or a deterioration of an existing weakness, which could seriously affect Departmental plans or operations must be brought to the attention of the CFO through the appropriate MCCs. Such identification can also occur during the risk rating process.

3-9. **Responsibilities.**

A. The CFO:

1. Monitors performance and completion of MCRs and AMCRs;
2. Provides appropriate technical and functional support for reviews;
3. Maintains the Department's Risk Management Database;
4. Provides quality assurance reviews of MCRs and AMCRs, corrective action follow-up and other suggestions for improvement; and
5. Coordinates applicable evaluation activities, such as OIG and GAO audits, management reviews, and special studies.

B. POHs must:

1. Ensure that the MCC position is properly staffed and operational;
2. Ensure coordination with other Headquarters' offices;
3. Alert the CFO of emerging mission-critical problems or deterioration of existing weaknesses which could seriously affect Departmental plans or operations.

C. MCCs review and sign-off on the MCR/AMCR documentation, and alert senior management officials of serious problems identified as a result of MCRs/AMCRs.

1. Develop tracking and follow up to ensure that review recommendations are completed;
2. Review and approve by signing review reports and other documents for completeness and quality; and
4. Ensure that adequate documentation of the reviews is retained for quality assurance.

D. Managers must:

1. Ensure that reviews are conducted as scheduled by knowledgeable staff;
2. Retain written documentation of actions taken; and
3. Implement corrective actions as necessary.

EXHIBIT 3-1

MATERIAL WEAKNESSES

Material weaknesses may be disclosed by management control evaluations, special risk management reviews, OIG or GAO audits, and other efforts undertaken to comply with the FMFIA. POHs bear the primary responsibility for determining whether existing control weaknesses are material. The OIG or GAO may identify in their reports situations which they believe are material weaknesses. Management should use these reports as a guide, but should not limit material weaknesses reported to only those identified in audit reports and control reviews.

POHs are responsible for reporting all material weaknesses to the Secretary in their annual assurance reports. Final determinations regarding inclusion of material weaknesses in the FMFIA Report to the President and Congress are made by the Secretary on the recommendation of the CFO. For guidance in determining which weaknesses affecting a functional area should be reported as material, any situation meeting one or more of the following criteria for Section 2 or Section 4 of FMFIA should be considered:

A. Assessing Materiality of Weaknesses - FMFIA Section 2

For purposes of determining what constitutes a material weakness in management control systems, these should be used. The criteria require reporting weaknesses that:

1. Significantly impair the fulfillment of an agency or component's mission;
2. Deprive the public of needed services;
3. Violate statutory or regulatory requirements;
4. Significantly weaken safeguards against waste, loss, unauthorized use, or misappropriation of funds, property, or other assets;
5. Result in a conflict of interest;
6. Merit the attention of the agency head/senior management, the Executive Office of the President, or the relevant Congressional oversight committee; or
7. Are of a nature that omission from the report could reflect adversely on the actual or perceived management integrity of the agency.

B. Assessing Materiality of Weaknesses - FMFIA Section 4

Each material non-conformance (Section 4) in a financial system should meet one or more of the following criteria:

1. Merits the attention of the agency head/senior management, the Executive Office of the President, or the relevant Congressional oversight committee;
2. Prevents the primary agency financial system from achieving central control over agency financial transactions and resource balances; or

3. Prevents conformance of financial systems with (A) financial information standards and/or (B) financial system functional standards.
 - (A) Financial information standards are:
 - (1) Compliance with SGL: implementation of the U.S. Government Standard General Ledger (crosswalks acceptable); and
 - (2) Data quality: accurate, complete, reliable, timely, comparable, consistent, useful financial information for the current and past fiscal years;
 - (B) Financial system functional standards are:
 - (1) Compliance with JFMIP Core Requirements: compliance with financial system functional requirements published by JFMIP and approved by OMB, Treasury and GAO, which include general ledger control (including fund control) over agency resources, obligations and spending;
 - (2) Effective interfaces: single entry of data or adequate reconciliation among systems;
 - (3) Documentation/audit trails: adequate systems documentation and audit trails; and
 - (4) Support of mission performance: adequate overall system performance in support of agency's assigned mission and information needs.