



441 G St. N.W.  
Washington, DC 20548

Accessible Version

June 14, 2017

The Honorable Melvin Watt  
Director  
Federal Housing Finance Agency

## Management Report: Opportunities for Improvement in FHFA's Evaluation of Internal Control over Financial Reporting

Dear Mr. Watt:

On November 15, 2016, we issued our report containing our opinion on the fiscal years 2016 and 2015 financial statements of the Federal Housing Finance Agency (FHFA).<sup>1</sup> Our report also included (1) our opinion on the effectiveness of FHFA's internal control over financial reporting as of September 30, 2016, and (2) our conclusion on FHFA's compliance during fiscal year 2016 with selected provisions of applicable laws, regulations, contracts, and grant agreements that we tested.

We did not identify and therefore did not report any material weaknesses or significant deficiencies in our November 2016 audit report.<sup>2</sup> The purpose of this report is to communicate other less significant control deficiencies identified during our fiscal year 2016 audit but not included in our audit report. There were no prior recommendations outstanding for FHFA related to past financial statement audits.

The Housing and Economic Recovery Act of 2008 (HERA)<sup>3</sup> established FHFA as an independent agency empowered with supervisory and regulatory oversight of the housing-related government-sponsored enterprises: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the 11 Federal Home Loan Banks, and the Office of Finance.<sup>4</sup> The act requires FHFA to annually prepare financial statements and requires GAO to audit these statements.<sup>5</sup> It also requires the FHFA Director to provide the Comptroller General an annual assertion as to the effectiveness of internal control

<sup>1</sup>GAO, *Financial Audit: Federal Housing Finance Agency's Fiscal Years 2016 and 2015 Financial Statements*, [GAO-17-139R](#) (Washington, D.C.: Nov. 15, 2016).

<sup>2</sup>A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

<sup>3</sup>Pub. L. No. 110-289, 122 Stat. 2654 (July 30, 2008).

<sup>4</sup>The 11 Federal Home Loan Banks and the Office of Finance, whose primary function is to issue and service all debt securities for the Federal Home Loan Banks, constitute the Federal Home Loan Bank System.

<sup>5</sup>Pub. L. No. 110-289, § 1106, 122 Stat. 2654, 2671 (July 30, 2008), *classified at* 12 U.S.C. § 4516.

over financial reporting.<sup>6</sup> FHFA issues consolidated financial statements that include the financial activities and position of FHFA and the FHFA Office of the Inspector General (FHFA-OIG) as a single reporting entity. Since FHFA-OIG is material to FHFA's financial statements, the evaluation of its internal control over financial reporting is a key component of FHFA's assertion. While FHFA and FHFA-OIG perform the evaluations of internal control independently, FHFA is ultimately responsible for consolidating the evaluation results and providing an annual assertion as to the effectiveness of internal control over financial reporting for the agency as a whole.

## Results in Brief

During our audit of FHFA's fiscal years 2016 and 2015 financial statements, we identified deficiencies in FHFA's evaluation of internal control over financial reporting. This includes FHFA-OIG's evaluation of its own internal control over financial reporting as FHFA-OIG's reported amounts constitute a material portion of the consolidated FHFA financial statements. FHFA's evaluation is used to support its assurance statement on the effectiveness of internal control over financial reporting and is essential to the monitoring component of internal control. While we did not consider these deficiencies to be material weaknesses or significant deficiencies, either individually or collectively, they nonetheless warrant FHFA management's attention. Specifically, we found that during FHFA's internal control evaluation, FHFA and FHFA-OIG did not (1) adequately document their consideration of materiality thresholds and risk assessments, (2) adequately document their consideration of all internal control components and related principles, and (3) adequately identify and document financial reporting control activities. In addition, FHFA did not maintain independent roles in the implementation and monitoring of control activities.

We are making nine recommendations pertaining to these identified control deficiencies.

## Scope and Methodology

As part of our audit of FHFA's fiscal years 2016 and 2015 financial statements, we evaluated FHFA's (including FHFA-OIG's) internal controls and tested its compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements. We designed our audit procedures to test relevant controls over financial reporting, including those designed to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of FHFA's financial statements in accordance with U.S. generally accepted accounting principles, and that assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority; regulations; contracts; and grant agreements, noncompliance with which could have a material effect on the financial statements. As part of our audit, we evaluated the work performed and conclusions reached by FHFA management in its internal control evaluation.<sup>7</sup> A full discussion of our scope and methodology is included in our November 2016 report on our audit of FHFA's fiscal years 2016 and 2015 financial statements.<sup>8</sup>

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<sup>6</sup>12 U.S.C. § 4516(g)(4).

<sup>7</sup>FHFA's internal control over financial reporting is governed by criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act.

<sup>8</sup>[GAO-17-139R](#).

We performed our audit in accordance with U.S. generally accepted government auditing standards. We believe that our audit provides a reasonable basis for our findings and recommendations in this report.

### Deficiencies in FHFA's Evaluation of Internal Control over Financial Reporting

During our fiscal year 2016 audit, we identified deficiencies in FHFA's evaluation of internal control over financial reporting. This includes FHFA-OIG's evaluation of its own internal control over financial reporting as FHFA-OIG's reported amounts constitute a material portion of the consolidated FHFA financial statements. FHFA's evaluation is used to support its assurance statement on the effectiveness of internal control over financial reporting and is essential to the monitoring component of internal control. Specifically, we found that FHFA and FHFA-OIG did not (1) adequately document their consideration of materiality thresholds and risk assessments, (2) adequately document their consideration of all internal control components and related principles, and (3) adequately identify and document financial reporting control activities. In addition, FHFA did not maintain independent roles in the implementation and monitoring of control activities.

Although FHFA and we concluded that its internal control over financial reporting was effective as of September 30, 2016, we noted the following deficiencies.

#### **Documenting the Consideration of Materiality Thresholds and Risk Assessments**

FHFA and FHFA-OIG utilize a 3-year testing cycle for their evaluations of internal control over financial reporting by process area. For example, payroll processing and depreciation are two separate process areas (i.e., financial reporting functions) that affect the program costs line item in the Statement of Net Cost. Each process area is tested at least once during the 3-year cycle, and materiality and risk are to be considered when determining which processes to select for testing in a given year. FHFA and FHFA-OIG document the processes selected for testing and submit them for approval to the Chief Financial Officer and the Deputy Inspector General for Internal Controls and Facilities, respectively. FHFA and FHFA-OIG analyze the results of their testing and draw conclusions on internal control over financial reporting independently. FHFA-OIG then reports its conclusions to FHFA for consideration when forming overall conclusions on internal control over financial reporting for the agency as a whole.

#### Condition.

We found that FHFA and FHFA-OIG did not adequately document how materiality thresholds and risk assessments were considered in planning their evaluations of internal control over financial reporting. For example, during FHFA's planning of its internal control evaluation, it developed a table that included its explanations for selecting process areas for testing. However, the explanations made no explicit reference to the materiality threshold or assessed risk. For instance, FHFA changed to a new payroll provider in September 2015, shortly before fiscal year 2016 started. FHFA considered this change, which affects risk, when selecting processes for testing. However, it did not document the significance of the risk or assign a risk assessment level for this process area during planning. Furthermore, FHFA did not document a risk assessment level for any of the process areas. Similarly, FHFA-OIG's memorandum on process areas selected for testing did not explicitly document how it considered materiality and risk when obtaining approval for process areas selected for testing.

We also found that FHFA's and FHFA-OIG's documentation did not consider materiality thresholds for the agency as a whole or adequately explain the rationale for materiality calculations. For example, FHFA and FHFA-OIG calculated materiality thresholds independently, using different materiality benchmarks. Specifically, FHFA determined Obligations Incurred to be its most significant line item and used that balance as its materiality benchmark, while FHFA-OIG used adjusted program costs. However, FHFA and FHFA-OIG did not document how they reasonably assured that the different materiality thresholds they calculated were appropriate for the agency as a whole, considering FHFA issues consolidated financial statements. In addition, FHFA did not explain its rationale for determining Obligations Incurred to be its most significant line item, and FHFA-OIG did not explain its rationale for excluding certain expenses from program costs when determining the materiality benchmark it used.

Furthermore, although FHFA and FHFA-OIG established materiality thresholds for testing, they did not evaluate the aggregate effect of all deficiencies identified at the agency-wide level.

### Criteria.

*Standards for Internal Control in the Federal Government* states that management should establish and operate monitoring activities to monitor the internal control system and evaluate the results. Management can use separate evaluations to monitor the design and operating effectiveness of the internal control system. The scope and frequency of these evaluations depend primarily on the assessment of risks,<sup>9</sup> effectiveness of ongoing monitoring, and rate of change within the entity and its environment.<sup>10</sup> Furthermore, Appendix A of the Office of Management and Budget's (OMB) Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*,<sup>11</sup> states that an assessment of the potential effectiveness of the design of controls for an account or group of accounts should be made considering the risk of error, and that materiality should be considered when determining the extent of testing or work required to assess internal control over financial reporting as well as what deficiencies should be reported. In addition, per the implementation guide for Appendix A of OMB Circular A-123,<sup>12</sup> management should document the rationale and basis for the materiality determination and also decide which reportable conditions, when aggregated, may be deemed material weaknesses to the agency as a whole.

### Cause.

FHFA and FHFA-OIG did not adequately consider and document materiality thresholds and risk when designing the evaluation of internal control over financial reporting because neither entity

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<sup>9</sup>Management defines risk tolerances in specific and measurable terms so they are clearly stated and can be measured. Risk tolerance is often measured in the same terms as the performance measures for the defined objectives. Financial reporting objectives include judgments about materiality in light of surrounding circumstances, involve both qualitative and quantitative considerations, and are affected by the needs of financial report users and size or nature of a misstatement.

<sup>10</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014).

<sup>11</sup>Office of Management and Budget, *Management's Responsibility for Enterprise Risk Management and Internal Control*, OMB Circular A-123 (Washington, D.C.: July 2016).

<sup>12</sup>Chief Financial Officer's Council, *Implementation Guide for OMB Circular A-123, Management's Responsibility for Internal Control, Appendix A, Internal Control over Financial Reporting* (Washington, D.C.: July 2005).

developed a mechanism, such as a template, that captured all of the key aspects of the decision-making process. Furthermore, FHFA and FHFA-OIG did not coordinate with each other to (1) reasonably assure that the materiality thresholds were appropriate for the agency as a whole and (2) assess the aggregate effect of all deficiencies identified at the agency-wide level.

### Effect.

Without adequately documenting materiality and risk considerations when evaluating internal control over financial reporting, FHFA and FHFA-OIG are at increased risk that their testing may be insufficient to support the agency's assertion on the effectiveness of internal control over financial reporting.

### Recommendations for Executive Action.

We recommend that you take the following three actions:

- Direct the Chief Financial Officer to develop a mechanism that captures all of the key factors to be considered, such as materiality and risk, when designing the evaluation of internal control over financial reporting and collaborate, as appropriate, with the Inspector General to develop a similar mechanism for use by FHFA-OIG.
- Direct the Chief Financial Officer to coordinate with the Inspector General, as appropriate, when calculating materiality thresholds to reasonably assure that materiality determinations are appropriate for the agency as a whole and rationale is adequately documented.
- Direct the Chief Financial Officer to coordinate with the Inspector General, as appropriate, to assess and document the aggregate effect of all deficiencies identified at the agency-wide level during the evaluation of internal control over financial reporting.

### **Documenting the Consideration of Internal Control Components and Related Principles**

In addition to its annual assertion on internal control, FHFA also issues an annual statement of assurance in accordance with the Federal Managers' Financial Integrity Act.<sup>13</sup> As part of this process, the FHFA and FHFA-OIG program offices complete Internal Control Assessment forms based on the five components of internal control and 17 related principles outlined in *Standards for Internal Control in the Federal Government*. FHFA's and FHFA-OIG's program offices assess and conclude on the internal control principles assigned to them based on the controls designed and implemented in their offices.

### Condition.

We found that FHFA and FHFA-OIG did not adequately document how they considered the components of internal control and related principles from the perspective of internal control over financial reporting. FHFA and FHFA-OIG relied significantly on the assessments completed by the program offices to support their conclusions on the components of internal control and related principles for financial reporting. While it is acceptable to leverage the work of the program offices, the results of these assessments cover controls beyond those within the scope of financial reporting, as not all program offices play a major role in designing and implementing key internal controls related to financial reporting. Therefore, it was unclear what specific

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<sup>13</sup>31 U.S.C. § 3512(c), (d).

information within these assessments FHFA and FHFA-OIG used to support their conclusions on internal control over financial reporting.

Although FHFA attempted to summarize the results of these assessments within a table included in its results document, it did not consolidate the work of the program offices in sufficient detail, by internal control principle, to support its conclusion on internal control over financial reporting. For instance, FHFA included in its table the assessment form completed by FHFA's Office of Minority and Women Inclusion. However, it was unclear what information from this assessment FHFA used that would have been within the financial reporting scope to support its conclusion on internal control over financial reporting.

In addition, FHFA-OIG did not summarize the results of the program office assessments within its conclusion on internal control over financial reporting. Therefore, FHFA-OIG did not adequately explain in its documentation how it considered all internal control components and related principles, as they relate to financial reporting, when arriving at its conclusion.

### Criteria.

HERA requires FHFA to provide an assertion on the effectiveness of internal control over financial reporting using *Standards for Internal Control in the Federal Government*. *Standards for Internal Control in the Federal Government* states that management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.<sup>14</sup> The five components of internal control must be effectively designed, implemented, and operating, and operating together in an integrated manner, for an internal control system to be effective. The 17 principles support the effective design, implementation, and operation of the associated components and represent requirements necessary to establish an effective internal control system. For each principle, management makes a summary determination as to whether the principle is designed, implemented, and operating effectively.

Furthermore, the implementation guide for Appendix A of OMB Circular A-123 states that management should determine the scope of the internal control assessment, specifically the breadth and depth of financial reporting, and maintain documentation of the assessment process and methodology used to support its assertion as to the effectiveness of the internal control over financial reporting.

### Cause.

FHFA management stated that they consider the evaluation of internal control over financial reporting to be low risk given the ongoing monitoring performed by the agency. As a result, it allocates limited resources to the separate evaluation performed for internal control over financial reporting. However, per Appendix A of OMB Circular A-123, management should ensure that adequate funding and resources are made available for the evaluation of internal control over financial reporting. In addition, FHFA-OIG stated that it did not fully understand the need to document how it considered all internal control components and related principles, as they relate to financial reporting, based on the standards when arriving at its conclusion.

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<sup>14</sup>[GAO-14-704G](#).

## Effect.

Without adequate documenting of their consideration of all internal control components and related principles within the scope of financial reporting, there is an increased risk of FHFA and FHFA-OIG inaccurately concluding, or inadequately supporting their conclusions, on the effectiveness of internal control over financial reporting.

## Recommendation for Executive Action.

We recommend that you direct the Chief Financial Officer to (1) summarize in sufficient detail by internal control principle those activities from the program offices that have an effect on internal control over financial reporting to reasonably assure the consideration of all internal control components and related principles;

(2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG; and (3) document how that information is used to conclude on the internal control components and related principles for financial reporting.

## **Identifying and Documenting Financial Reporting Control Activities**

To support the assurance statement on the effectiveness of internal control over financial reporting, FHFA and FHFA-OIG, among other things, are to assess key control activities related to key process areas, service providers, and information systems. Furthermore, they are to assess key control activities to reasonably assure compliance with laws and regulations. FHFA and FHFA-OIG categorize their internal control over financial reporting into 32 and 27 process areas, respectively. Examples of some process areas include payroll processing, invoice processing, and depreciation.

In addition, FHFA and FHFA-OIG contract with several service providers for specific services. For accounting and reporting services, they both contract with the Department of the Treasury's Bureau of the Fiscal Service (Fiscal Service). Fiscal Service undergoes an annual examination on the suitability of the design and operating effectiveness of its controls, and the results of the examination are issued in a Statement on Standards for Attestation Engagements (SSAE) No. 16 report.<sup>15</sup> The SSAE No. 16 report also includes complementary user entity controls, which are controls to be implemented by user entities (i.e., FHFA and FHFA-OIG) to achieve the control objectives stated in the SSAE No. 16 report. FHFA and FHFA-OIG rely on the control testing results documented in the SSAE No. 16 reports of their service providers.

Similarly, in addition to SSAE No. 16 examinations, FHFA and FHFA-OIG rely on work performed by other auditors for their evaluation of information system controls, such as the annual Federal Information Security Management Act audit. Furthermore, FHFA and FHFA-OIG implement controls to reasonably assure compliance with those laws and regulations that have an impact on material amounts and disclosures in the financial statements.

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<sup>15</sup>The examination is performed by an independent service auditor in accordance with generally accepted government auditing standards and the American Institute of Certified Public Accountants' SSAE No. 16, *Reporting on Controls at a Service Organization*. The Department of the Treasury's Office of Inspector General issued the SSAE No. 16 report on September 1, 2016, covering the period July 1, 2015, through June 30, 2016. SSAE No. 16 was superseded by SSAE No.18, *Attestation Standards: Clarification and Recodification*, effective May 1, 2017.

### Condition.

As part of their evaluation, FHFA and FHFA-OIG did not adequately identify or document all key financial reporting control activities related to key process areas, service providers, information systems, and compliance with laws and regulations.

FHFA did not identify all key control activities or process areas for testing. For example, FHFA did not identify all key control activities for fixed assets and year-end accruals. Also, in its list of process areas containing key controls, FHFA did not identify the preparation of the financial statements, which should include key control activities such as management approval of the year-end financial statements.

In addition, FHFA's and FHFA-OIG's reviews of Fiscal Service's SSAE No. 16 report did not identify all applicable control objectives and key control activities at Fiscal Service relevant to FHFA's financial reporting. For example, Fiscal Service processes manual journal entries on behalf of both FHFA and FHFA-OIG. However, neither entity identified this objective as applicable to it and, as a result, did not identify any key control activities for the objective. In addition, FHFA's documentation of the SSAE No. 16 control activities was not sufficiently detailed to determine which control activities FHFA took into consideration to support its overall evaluation. Furthermore, while FHFA and FHFA-OIG implemented complementary user entity controls as documented in the SSAE No. 16 report, neither entity adequately documented how it evaluated these controls as part of its internal control evaluation.

Although FHFA and FHFA-OIG considered information systems control activities in evaluating internal control over financial reporting and reviewed the testing results of separate evaluations performed for their information systems, they did not identify a complete list of the specific control activities tested in those audits and examinations that were key to financial reporting. For instance, during planning, FHFA and FHFA-OIG stated that they would rely on SSAE No. 16 reports and other audit results for their evaluation of information systems control activities; however, they did not identify the specific information systems control activities key to financial reporting. After reviewing the SSAE No. 16 reports and other audit results, neither entity developed a complete list of the specific information systems control activities that were key to financial reporting. They also did not document whether the testing that other auditors performed was sufficient to meet the objectives of internal control over financial reporting.

Moreover, although FHFA-OIG considered compliance with laws and regulations as part of its evaluation of internal control over financial reporting, it did not clearly link the control activities being tested within a process area to the specific law or regulation being evaluated. For instance, for the payroll disbursements process area, FHFA-OIG indicated in its internal control assessment document that compliance with laws and regulations was applicable. However, FHFA-OIG did not specify in that document the applicable provision of law or regulation that was considered when testing the control activities implemented to reasonably assure compliance.

### Criteria.

HERA requires FHFA to provide an assertion on the effectiveness of internal control over financial reporting using *Standards for Internal Control in the Federal Government*. *Standards for Internal Control in the Federal Government* states that management should establish and

operate monitoring activities to monitor the internal control system and evaluate the results.<sup>16</sup> Management can use separate evaluations to monitor the design and operating effectiveness of the internal control system, which includes control activities, at a specific time or of a specific function or process. This may include responsibility for monitoring the effectiveness of internal control over the assigned processes performed by service organizations to obtain reasonable assurance of the operating effectiveness of the service organization's internal controls. It may also include responsibility for the entity's information system as part of the internal control system. Furthermore, the standards state that external financial reporting objectives include objectives related to releasing the entity's financial performance in accordance with applicable laws and regulations. The standards also require that management document the results of separate evaluations.

### Cause.

FHFA and FHFA-OIG did not adequately identify and document financial reporting control activities for several reasons. First, FHFA management stated that they consider the evaluation of internal control over financial reporting to be low risk given the ongoing monitoring performed by the agency. As a result, it allocates limited resources to identify and document control activities for key financial reporting processes and service providers. However, per Appendix A of OMB Circular A-123, management should ensure that adequate funding and resources are made available for the evaluation of internal control over financial reporting. FHFA-OIG stated that while it considered service provider controls as part of its internal control evaluation, it did not fully understand the extent to which it should have documented all control activities implemented by its service provider, including its evaluation of complementary user entity controls.

In addition, FHFA and FHFA-OIG did not clearly define and document an approach that identified which information systems are key to financial reporting and which business processes these systems support which would enable them to identify specific control activities and explain how these control activities are evaluated as part of the internal control over financial reporting assertion.

Lastly, FHFA-OIG has not developed a complete list of the specific provisions of laws and regulations that may have an effect on material amounts and disclosures in the financial statements to clearly link the key control activities tested to reasonably assure compliance.

### Effect.

Without adequate identifying and documenting of all relevant financial reporting control activities related to key process areas, service providers, and information systems, there is an increased risk that FHFA and FHFA-OIG will not have adequate support for their evaluations of internal control over financial reporting. Furthermore, by not adequately documenting its evaluation of control activities over compliance with laws and regulations, FHFA-OIG is at increased risk of not having adequate support for its statement that transactions are executed in accordance with applicable laws and regulations, noncompliance with which could have a material effect on the financial statements.

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<sup>16</sup>[GAO-14-704G](#).

## Recommendations for Executive Action.

We recommend that you take the following four actions:

- Direct the Chief Financial Officer to enhance the evaluation of internal control over financial reporting by identifying and testing all key control activities, including those related to the preparation of the financial statements.
- Direct the Chief Financial Officer to (1) thoroughly document FHFA's review of SSAE No. 16 reports issued for the period under evaluation by reasonably assuring that all applicable control objectives and related control activities are clearly identified and described and the evaluation of user entity controls is adequately explained and (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG.
- Direct the Chief Financial Officer to (1) clearly define and document an approach that identifies the information systems that are key to financial reporting, the process areas these information systems support, the key control activities for each information system, and how the key control activities are evaluated and (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG.
- Direct the Chief Financial Officer to collaborate, as appropriate, with the Inspector General to (1) develop a complete list of the specific provisions of laws and regulations that may have an effect on material amounts and related disclosures in the financial statements that are applicable to FHFA-OIG and (2) prepare documentation that clearly links each applicable provision of law or regulation to the key control activities tested.

### **Independent Roles in the Implementation and Monitoring of Control Activities**

FHFA's Office of Budget and Financial Management (OBFM) contains a sub-division comprising three employees who have primary responsibility for the preparation of FHFA's financial statements. These individuals play a significant role in the implementation of control activities over financial reporting. Two employees within this sub-division also oversee the monitoring of internal control over financial reporting, which assesses the effective implementation of these control activities. Specifically, they develop an overall approach, conduct the testing of key internal control activities, report the evaluation results to senior management, and monitor the correction of identified deficiencies.

### Condition.

During our audit of FHFA, we found that FHFA's structure for its evaluation of internal control over financial reporting did not reasonably assure that independent roles were assigned for the implementation and monitoring of control activities. Specifically, we found instances in which the individual implementing the control activity was the same individual monitoring the control activity. For example, as mentioned above, FHFA contracts with Fiscal Service for accounting and reporting services. In the areas of accrued annual leave and imputed financing costs, the Fiscal Service supervisory accountant performs a review of these journal entries. However, FHFA OBFM's review and approval is required for these journal entries to be recorded in the general ledger; thus, we considered this to be the key control activity. The FHFA OBFM staff member responsible for reviewing and approving these journal entries was the same staff member responsible for monitoring and assessing the effectiveness of this control. Therefore, FHFA OBFM's role as monitor was not independent.

### Criteria.

HERA requires FHFA to provide an assertion on the effectiveness of internal control over financial reporting using *Standards for Internal Control in the Federal Government*. *Standards for Internal Control in the Federal Government* states that management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.<sup>17</sup> Management can monitor the internal control system through ongoing monitoring and separate evaluations. Separate evaluations may be used periodically and may provide feedback on the effectiveness of ongoing monitoring. In addition, separate evaluations provide greater objectivity when performed by reviewers who do not have responsibility for the activities being evaluated.

### Cause.

FHFA management considers the separate evaluation performed for the monitoring component of internal control to be low risk for the agency primarily because FHFA conducts ongoing monitoring. Therefore, FHFA did not allocate additional resources to perform the separate evaluation to monitor FHFA's internal control over financial reporting. However, per Appendix A of OMB Circular A-123, management should ensure that adequate funding and resources are made available for the evaluation of internal control over financial reporting.

### Effect.

By not maintaining independent roles between the implementation and monitoring of control activities, FHFA cannot reasonably assure that it is receiving objective evaluations on the effectiveness of its controls, which could lead to inaccurately concluding, or inadequately supporting its conclusions, on the effectiveness of internal control over financial reporting.

### Recommendation for Executive Action.

We recommend that you direct the Chief Financial Officer to design an evaluation process that reasonably assures assignment of independent roles between the implementation and monitoring of control activities that are significant to the evaluation of internal control over financial reporting.

### Agency Comments and Our Evaluation

We provided a draft of this report to FHFA for comment. In its written comments, reprinted in enclosure I, FHFA stated that it agreed with the nine recommendations we made in the report and described actions it is taking or plans to take to address each recommendation. Such actions include enhancing the documentation of its internal control evaluation and hiring an independent contractor to aid in the evaluation process for fiscal year 2017. We will evaluate FHFA's actions for addressing the deficiencies identified in this report as part of our audit of FHFA's fiscal year 2017 financial statements.

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This report contains recommendations to you. As you know, 31 U.S.C. § 720, as recently amended, requires the head of a federal agency to submit a written statement on actions taken or planned on these recommendations. You should submit your statement to the Senate

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<sup>17</sup>[GAO-14-704G](#).

Committee on Homeland Security and Governmental Affairs, the House Committee on Oversight and Government Reform, the congressional committees with jurisdiction over the programs and activities that are the subject of our recommendations, and GAO within 60 days of the date of this report. A written statement must also be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report. Please send your statement of actions to me at [malenichj@gao.gov](mailto:malenichj@gao.gov) and Nina M. Rostro, Assistant Director, at [rostron@gao.gov](mailto:rostron@gao.gov).

We are sending copies of this report to the Secretary of the Treasury, the Secretary of Housing and Urban Development, the Chairperson of the Securities and Exchange Commission, the Director of the Office of Management and Budget, and other interested parties. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by FHFA officials and staff during our audit of FHFA's fiscal years 2016 and 2015 financial statements. If you or your staff have any questions about this report, please contact me at (202) 512-3406 or [malenichj@gao.gov](mailto:malenichj@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in enclosure II.

Sincerely yours,

A handwritten signature in blue ink that reads "J. Lawrence Malenich". The signature is written in a cursive style with a large initial "J".

J. Lawrence Malenich  
Director  
Financial Management and Assurance

Enclosures – 2

## Enclosure I: Comments from the Federal Housing Finance Agency



### Federal Housing Finance Agency

#### MEMORANDUM

TO: J. Lawrence Malenich, Director, Financial Management and Assurance,  
Government Accountability Office

FROM: Mark Kinsey, Chief Financial Officer, Federal Housing Finance Agency 

SUBJECT: *Management Report: Opportunities for Improvement in FHFA's Evaluation of Internal Control over Financial Reporting*

DATE: May 23, 2017

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Thank you for the opportunity to respond to the Government Accountability Office (GAO) draft report titled, *Management Report: Opportunities for Improvement in FHFA's Evaluation of Internal Control over Financial Reporting* (Report).

FHFA and FHFA OIG evaluated the Report's findings and recommendations. FHFA's responses to the Report's recommendations follow.

#### **Documenting the Consideration of Materiality Thresholds and Risk Assessments**

##### Recommendation 1:

*Direct the Chief Financial Officer to develop a mechanism that captures all the key factors to be considered, such as materiality and risk, when designing the evaluation of internal control over financial reporting and collaborate, as appropriate, with the Inspector General to develop a similar mechanism for use by FHFA-OIG.*

##### Management Response to Recommendation 1:

FHFA agrees with the recommendation. FHFA is in the process of developing a mechanism that captures key factors, including risk and materiality, when designing the evaluation of internal control over financial reporting. This mechanism will be documented for the FY 2017 evaluation of internal control over financial reporting. FHFA and FHFA OIG are collaborating in these efforts.

Recommendation 2:

*Direct the Chief Financial Officer to coordinate with the Inspector General, as appropriate, when calculating materiality thresholds to reasonably assure that materiality determinations are appropriate for the agency as a whole and rationale is adequately documented.*

Management Response to Recommendation 2:

FHFA agrees with the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will coordinate with the FHFA OIG when calculating materiality thresholds to reasonably assure that materiality determinations are appropriate for the Agency as a whole and the rationale is adequately documented.

Recommendation 3:

*Direct the Chief Financial Officer to coordinate with the Inspector General, as appropriate, to assess and document the aggregate effect of all deficiencies identified at the agency-wide level during the evaluation of internal control over financial reporting.*

Management Response to Recommendation 3:

FHFA agrees with the recommendation. FHFA will coordinate with FHFA OIG during the FY 2017 evaluation of internal control over financial reporting to assess and document the aggregate effect of all deficiencies identified at the Agency-wide level.

**Documenting the Consideration of Internal Control Components and Related Principles**

Recommendation 4:

*We recommend that you direct the Chief Financial Officer to (1) summarize in sufficient detail by internal control principle those activities from the program offices that have an effect on internal control over financial reporting to reasonably assure the consideration of all internal control components and related principles; (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG; and (3) document how that information is used to conclude on the internal control components and related principles for financial reporting.*

Management Response to Recommendation 4:

FHFA agrees with the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will summarize by internal control principle those activities from the program offices that have an effect on internal control over financial reporting to reasonably assure the consideration of all internal control components and related principles. FHFA will also document how information is used to conclude on the internal control components and related principles for financial reporting activities that are evaluated. FHFA will collaborate with FHFA OIG in these efforts.

**Identifying and Documenting Financial Reporting Control Activities**

Recommendation 5:

*Direct the Chief Financial Officer to enhance the evaluation of internal control over financial reporting by identifying and testing all key control activities, including those related to the preparation of the financial statements.*

Management Response to Recommendation 5:

FHFA agrees with the recommendation. FHFA will enhance the FY 2017 evaluation of internal control over financial reporting by identifying and testing all key control activities, including those related to the preparation of the financial statements.

Recommendation 6:

*Direct the Chief Financial Officer to (1) thoroughly document FHFA's review of SSAE No. 16 reports issued for the period under evaluation by reasonably assuring that all applicable control objectives and related control activities are clearly identified and described and the evaluation of user entity controls is adequately explained and (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG.*

Management Response to Recommendation 6:

FHFA agrees to the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will thoroughly document FHFA's review of SSAE No. 16 reports issued for the period under evaluation by reasonably assuring that all applicable control objectives and related control activities are clearly identified and described and the evaluation of

user entity controls is adequately explained. FHFA will collaborate with FHFA OIG during these efforts.

Recommendation 7:

*Direct the Chief Financial Officer to (1) clearly define and document an approach that identifies the information systems that are key to financial reporting, the process areas these information systems support, the key control activities for each information system, and how the key control activities are evaluated and (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG.*

Management Response to Recommendation 7:

FHFA agrees with the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will clearly define and document an approach that identifies the information systems that are key to financial reporting, the process areas these information systems support, the key control activities for each information system, and how the key control activities are evaluated. FHFA will collaborate with FHFA OIG in these efforts.

Recommendation 8:

*Direct the Chief Financial Officer to collaborate, as appropriate, with the Inspector General to (1) develop a complete list of the specific provisions of laws and regulations that may have an effect on material amounts and related disclosures in the financial statements that are applicable to FHFA-OIG and (2) prepare documentation that clearly links each applicable provision of law or regulation to the key control activities tested.*

Management Response to Recommendation 8:

FHFA agrees with the recommendation. FHFA will collaborate with FHFA OIG to develop a complete list of the specific provisions of laws and regulations that may have an effect on material amounts and related disclosures in the financial statements that are applicable to FHFA OIG and prepare documentation that clearly links each applicable provision of law or regulation to the key control activities tested.

**Independent Roles in the Implementation and Monitoring of Control Activities**

Recommendation 9:

*We recommend that you direct the Chief Financial Officer to design an evaluation process that reasonably assures assignment of independent roles between the implementation and monitoring of control activities that are significant to the evaluation of internal control over financial reporting.*

Management Response to Recommendation 9:

FHFA agrees with the recommendation. FHFA is designing an evaluation process that reasonably assures assignment of independent roles between implementation and monitoring of control activities that are significant to the evaluation of internal control over financial reporting. To this end, FHFA has hired an independent contractor to aid in the evaluation process for FY 2017, and has involved staff from FHFA's Office of Quality Assurance in the FY 2017 evaluation process to reasonably assure independent roles between monitoring and implementation going forward.

I would like to acknowledge the dedicated GAO staff that worked with FHFA during the audit.

If you have any questions relating to our response, please do not hesitate to call me at (202) 649-3780.

## Text of Enclosure I: Comments from the Federal Housing Finance Agency

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Federal Housing Finance Agency

MEMORANDUM

TO: J. Lawrence Malenich, Director, Financial Management and Assurance, Government Accountability Office

FROM: SUBJECT: Mark Kinsey, Chief Financial Officer, Federal Housing Finance Agency

Management Report: Opportunities for Improvement in FHFA's Evaluation of Internal Control over Financial Reporting

DATE: May 23, 2017

Thank you for the opportunity to respond to the Government Accountability Office (GAO) draft report titled, Management Report: Opportunities for Improvement in FHFA's Evaluation of Internal Control over Financial Reporting (Report).

FHFA and FHFA OIG evaluated the Report's findings and recommendations. FHFA's responses to the Report's recommendations follow.

Documenting the Consideration of Materiality Thresholds and Risk Assessments

#### Recommendation 1:

Direct the Chief Financial Officer to develop a mechanism that captures all the key factors to be considered, such as materiality and risk, when designing the evaluation of internal control over financial reporting and collaborate, as appropriate, with the Inspector General to develop a similar mechanism for use by FHFA-OIG.

#### Management Response to Recommendation 1:

FHFA agrees with the recommendation. FHFA is in the process of developing a mechanism that captures key factors, including risk and materiality, when designing the evaluation of internal control over financial reporting. This mechanism will be documented for the FY 2017 evaluation of internal control over financial reporting. FHFA and FHFA OIG are collaborating in these efforts.

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#### Recommendation 2:

Direct the Chief Financial Officer to coordinate with the Inspector General, as appropriate, when calculating materiality thresholds to reasonably assure that materiality determinations are appropriate for the agency as a whole and rationale is adequately documented.

### Management Response to Recommendation 2:

FHFA agrees with the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will coordinate with the FHFA OIG when calculating materiality thresholds to reasonably assure that materiality determinations are appropriate for the Agency as a whole and the rationale is adequately documented.

### Recommendation 3:

Direct the Chief Financial Officer to coordinate with the Inspector General, as appropriate, to assess and document the aggregate effect of all deficiencies identified at the agency-wide level during the evaluation of internal control over financial reporting.

### Management Response to Recommendation 3:

FHFA agrees with the recommendation. FHFA will coordinate with FHFA OIG during the FY 2017 evaluation of internal control over financial reporting to assess and document the aggregate effect of all deficiencies identified at the Agency-wide level.

Documenting the Consideration of Internal Control Components and Related Principles

### Recommendation 4:

We recommend that you direct the Chief Financial Officer to (1) summarize in sufficient detail by internal control principle those activities from the program offices that have an effect on internal control over financial reporting to reasonably assure the consideration of all internal control components and related principles; (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG; and (3) document how that information is used to conclude on the internal control components and related principles for financial reporting.

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### Management Response to Recommendation 4:

FHFA agrees with the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will summarize by internal control principle those activities from the program offices that have an effect on internal control over financial reporting to reasonably assure the consideration of all internal control components and related principles. FHFA will also document how information is used to conclude on the internal control components and related principles for financial reporting activities that are evaluated. FHFA will collaborate with FHFA OIG in these efforts.

Identifying and Documenting Financial Reporting Control Activities

### Recommendation 5:

Direct the Chief Financial Officer to enhance the evaluation of internal control over financial reporting by identifying and testing all key control activities, including those related to the preparation of the financial statements.

#### Management Response to Recommendation 5:

FHFA agrees with the recommendation. FHFA will enhance the FY 2017 evaluation of internal control over financial reporting by identifying and testing all key control activities, including those related to the preparation of the financial statements.

#### Recommendation 6:

Direct the Chief Financial Officer to (1) thoroughly document FHFA 's review of SSAE No. 16 reports issued for the period under evaluation by reasonably assuring that all applicable control objectives and related control activities are clearly identified and described and the evaluation of user entity controls is adequately explained and (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG.

#### Management Response to Recommendation 6:

FHFA agrees to the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will thoroughly document FHFA's review of SSAE No. 16 reports issued for the period under evaluation by reasonably assuring that all applicable control objectives and related control activities are clearly identified and described and the evaluation of

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user entity controls is adequately explained. FHFA will collaborate with FHFA OIG during these efforts.

#### Recommendation 7:

Direct the Chief Financial Officer to (1) clearly define and document an approach that identifies the information systems that are key to financial reporting, the process areas these information systems support, the key control activities for each information system, and how the key control activities are evaluated and (2) collaborate, as appropriate, with the Inspector General to implement corresponding actions at FHFA-OIG.

#### Management Response to Recommendation 7:

FHFA agrees with the recommendation. During the FY 2017 evaluation of internal control over financial reporting, FHFA will clearly define and document an approach that identifies the information systems that are key to financial reporting, the process areas these information systems support, the key control activities for each information system, and how the key control activities are evaluated. FHFA will collaborate with FHFA OIG in these efforts.

#### Recommendation 8:

Direct the Chief Financial Officer to collaborate, as appropriate, with the Inspector General to (1) develop a complete list of the specific provisions of laws and regulations that may have an effect on material amounts and related disclosures in the financial statements that are applicable to FHFA-OIG and (2) prepare documentation that clearly links each applicable provision of law or regulation to the key control activities tested.

### Management Response to Recommendation 8:

FHFA agrees with the recommendation . FHFA will collaborate with FHFA OIG to develop a complete list of the specific provisions of laws and regulations that may have an effect on material amounts and related disclosures in the financial statements that are applicable to FHFA OIG and prepare documentation that clearly links each applicable provision of law or regulation to the key control activities tested.

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Independent Roles in the Implementation and Monitoring of Control Activities

### Recommendation 9:

We recommend that you direct the Chief Financial Officer to design an evaluation process that reasonably assures assignment of independent roles between the implementation and monitoring of control activities that are significant to the evaluation of internal control over financial reporting.

### Management Response to Recommendation 9:

FHFA agrees with the recommendation. FHFA is designing an evaluation process that reasonably assures assignment of independent roles between implementation and monitoring of control activities that are significant to the evaluation of internal control over financial reporting. To this end, FHFA has hired an independent contractor to aid in the evaluation process for FY 2017, and has involved staff from FHFA's Office of Quality Assurance in the FY 2017 evaluation process to reasonably assure independent roles between monitoring and implementation going forward.

I would like to acknowledge the dedicated GAO staff that worked with FHFA during the audit.

If you have any questions relating to our response, please do not hesitate to call me at (202) 649-3780.

## Enclosure II: GAO Contact and Staff Acknowledgments

### **GAO Contact**

J. Lawrence Malenich, (202) 512-3406 or [malenichj@gao.gov](mailto:malenichj@gao.gov)

### **Staff Acknowledgments**

In addition to the contact named above, Nina M. Rostro (Assistant Director), Megan McGehrin, and Daniel Flavin made key contributions to this report.