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**INDUSTRY PERSPECTIVES ON ACHIEVING
AUDIT READINESS**

HEARING

BEFORE THE

PANEL ON DEFENSE FINANCIAL MANAGEMENT
AND AUDITABILITY REFORM

OF THE

COMMITTEE ON ARMED SERVICES
HOUSE OF REPRESENTATIVES

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PANEL ON DEFENSE FINANCIAL MANAGEMENT
AND AUDITABILITY REFORM

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WITNESS RESPONSES TO QUESTIONS ASKED DURING THE HEARING:

[There were no Questions submitted during the hearing.]

QUESTIONS SUBMITTED BY MEMBERS POST HEARING:

[There were no Questions submitted post hearing.]

INDUSTRY PERSPECTIVES ON ACHIEVING AUDIT READINESS

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
PANEL ON DEFENSE FINANCIAL MANAGEMENT AND
AUDITABILITY REFORM,

Washington, DC, Thursday, November 17, 2011.

The panel met, pursuant to call, at 8:00 a.m. in room 2212, Rayburn House Office Building, Hon. K. Michael Conaway (chairman of the panel) presiding.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE FROM TEXAS, CHAIRMAN, PANEL ON DEFENSE MANAGEMENT AND AUDITABILITY CONTROL

Mr. CONAWAY. Thanks to everyone for being here at our last Panel on Defense meeting for the month of November. I would like to welcome our witnesses this morning to bring us industry's perspective on audit readiness.

Over the past 4 months we have heard from a variety of witnesses within Government, including representatives from the office of OSD [Office of the Secretary of Defense] and military department comptrollers; the Department of Defense functional communities; department Office of Inspector General; and the GAO [Government Accountability Office] on the challenges that the Department faces in achieving audit readiness and its efforts to resolve these issues.

Today, as the Panel nears the completion of its work, we turn to accounting firms that have experience out of the private sector, as well as within Government, to get their views on the impediments to DOD [Department of Defense] achieving auditability and the actions needed to address these challenges.

In addition to having experience performing work at various other entities, these firms are involved in almost every aspect of the Department's financial improvement and audit readiness efforts, ranging from assisting DOD components in implementing the FIAR [Financial Improvement and Audit Readiness] strategy, to assisting the Office of the Under Secretary of Defense, Comptroller, in performing its review of DOD's components' progress, and actually performing certain audits themselves.

Therefore, they can provide a well-informed point of view on the problems facing DOD as it works toward achieving auditability on the statement of budgetary resources by 2014 and full financial statements by 2017.

Some of the challenges have been identified to date, including sustaining leadership and effective oversight, ensuring workforce

competency and implementing the ERPs [Enterprise Resource Planning], solving longstanding internal control weaknesses, and managing organizational challenges associated with having a large and complex organization such as DOD.

The witnesses here today may or may not consider all these issues as impediments to improving financial management and audit readiness, or they may have slightly different take on the issues, or they may identify other challenges altogether.

Most significantly, they may be able to provide alternative options on how to overcome these weaknesses.

I look forward to hearing their testimony. I would now like to introduce our witnesses. We have got Ms. JoAnn Boutelle, partner with Deloitte and Touche; Ms. Tracy Porter, partner with Grant Thornton; and Mr. Mark Keeley, partner with PricewaterhouseCoopers.

Now I would like to turn to Rob Andrews for any opening statement he would like to make.

[The prepared statement of Mr. Conaway can be found in the Appendix on page 25.]

STATEMENT OF HON. ROBERT ANDREWS, A REPRESENTATIVE FROM NEW JERSEY, RANKING MEMBER, PANEL ON DEFENSE FINANCIAL MANAGEMENT AND AUDITABILITY CONTROL

Mr. ANDREWS. Well, good morning, Chairman.

Good morning, ladies and gentlemen. I am glad to have you with us.

I will repeat something I have said as we have gone forward in this process; that we are on the verge of making very consequential decisions about the defense budget, either by default, through the sequestration process, or through a more deliberative mechanism through the Special Committee. But one way or another there is big decisions ahead.

And one thing I think that we all understand is that bad data lead to bad decisions, and bad recordkeeping systems lead to bad data. And it is an unfortunate presumption that the present state of affairs—because we do not have accurate financial statements from the Department of Defense—gives us too much bad data.

So this whole project is really not about some, you know, metaphysical accounting exercise—with all due respect to the chairman—don't want to insult accountants, but it is about a much larger and more substantive problem, which is if—that are we going to make these very consequential decisions with good information or without good information.

And I am encouraged by much of what I have heard from the Department of Defense and the Services and the various sub-units of the Services that are responsible for making us audit-ready by the statutory deadline.

But that is only half of the equation. I have been looking forward to this morning because it is the other half of the equation. We have been hearing from the people who are going to be preparing to be audited. We are now going to hear from the people who will be doing the audits and get your perspective on the audit readiness and the steps that stand between us and being totally audit-ready.

So we are glad that you are here. The spirit of this panel has always been to try to take information and use it in the best way possible, and we are glad that you are here to give us some of that information we can use.

So thank you, Mr. Chairman. I look forward to the testimony.

Mr. CONAWAY. Thanks, Rob.

Ms. Boutelle, your opening statement? And without objection, all your statements will be entered in the record. Your written statements will be entered in the record.

STATEMENT OF JOANN BOUTELLE, PARTNER, DELOITTE AND TOUCHE LLP

Ms. BOUTELLE. Thank you.

Chairman Conaway, Congressman Andrews and members of the Panel, thank you for the opportunity to testify today.

I have had the unique experience over the last 26 years serving in both Government and now industry. Prior to joining Deloitte in 2004, I worked as the Deputy Chief Financial Officer at DOD and before that at the Defense Finance and Accounting Service.

While serving as the DCFO [Deputy Chief Financial Officer], I recognized the managerial challenges caused by issues with the integrity of DOD financial data and led efforts to improve financial statements, business processes and systems.

It is from this experience that I offer my perspective on two areas which I think are critical to DOD's achieving auditability; first, an increase in sustained leadership commitment and, second, a workforce with the applicable financial and technical competencies.

I will talk about leadership first. A commitment from DOD leadership starting at the Secretary's level is critical to achieve audit readiness by 2017. This belief comes from Deloitte's direct experience working with both commercial and Government clients.

The chief financial officer and the DOD financial management community have demonstrated leadership in addressing the tough issues of fixing the Department's business processes and systems.

However, the business owners must also be held accountable to correct deficiencies that impact the Department's ability to achieve their audit goals. Cross-functional ownership at the senior levels cannot be forced by the CFO [Chief Financial Officer], who is a peer to many of the business leaders. This is a job for the Secretary and the Deputy Secretary, with tangible and measurable objectives.

Secretary Panetta's recent announcement that he is now personally involved in driving the Department to achieve audit readiness is a major signal that this is a top priority of the Department.

However, sustained participation from the Secretary and Deputy Secretary is critical to reinforcing the message throughout the Department that auditability is a top priority. Let me provide an example where a director of an agency became personally involved in achieving auditability. The Defense Information Systems Agency, or DISA, started on a journey in 2005 to obtain an audit opinion on its financial statements. The DISA director and others in leadership became personally involved and actively drove the audit readiness efforts, and recently DISA successfully completed an audit of their working capital fund.

The ongoing involvement of the DISA director was a major factor in their success.

Deloitte has seen similar examples in recent years on the commercial side where corporate CEOs [Chief Executive Officers] and COOs [Chief Operating Officers] aggressively led the implementation of the Sarbanes-Oxley Act. These organizations quickly learned that success required the full engagement of senior executives, not only in finance, but in the business units.

A similar pattern of sustained leadership engagement is critical to the Department's ability to meet its aggressive audit readiness time lines.

Now let me address the second critical area for success: The need to improve the competencies of the DOD workforce. Workforce development relating to financial management within the DOD should include three areas.

First, there are the people who are directly involved in the preparation of the Department's financial statements. There should be an increased effort to hire CPAs [Certified Public Accountants] into these key positions and also to incentivize current qualified employees to take the CPA exam.

Second, there are those nonfinancial managers who in the course of their daily jobs conduct activities that result in a financial transaction. Not all of these people need to be trained accountants, but they need to be trained to understand their role in financial management and why controls and timely processing of financial transactions are important to the integrity of the financial data.

Third, there are those financial managers in DOD who are directly involved in the financial statement audit and audit readiness process.

Leading these efforts requires CPAs with experience in complex financial statement audits. Getting to the first audit opinion is the most difficult step, and meeting the need for experienced audit professionals is critical to help DOD focus their resources most effectively.

The DOD does not have a sufficient number of CPAs with this experience. Since coming to Deloitte and working directly with seasoned audit practitioners, I have come to appreciate the difference between knowing how the Department processes and accounts for financial and budgetary transactions and knowing how to audit these transactions. DOD needs to recognize this difference.

In conclusion, DOD and its industry partners share the same goal—for DOD to achieve an unqualified audit opinion and for them to meet their deadlines.

I want to thank the Panel for holding these important hearings on defense financial management and for your laser-focused attention on this very important issue.

I look forward to your questions.

[The prepared statement of Ms. Boutelle can be found in the Appendix on page 27.]

Mr. CONAWAY. Thank you, Ms. Boutelle.

Ms. Porter.

**STATEMENT OF TRACY PORTER, PARTNER, GRANT
THORNTON LLP**

Ms. PORTER. Chairman Conaway, Ranking Member Andrews and distinguished members of the Panel, good morning and thank you for inviting me to testify today. I am pleased to be able to share with you my perspective on the impediments to DOD achieving audit readiness and the actions DOD needs to take to become audit-ready.

As you know, Grant Thornton was recently retained to perform the audit of the statement of budgetary resources of the United States Marine Corps. The results of that audit aren't the subject of my testimony today.

Instead, my views have been formed through years of conducting audits and audit readiness engagements for the Federal Government.

I know, for some, audit readiness at DOD may seem like a struggle that will not soon be won. But I have seen significant changes in recent past included a much stronger focus on improving financial management and not simply because of the audit.

Instead, there is a strong and sincere desire at DOD to give defense managers and warfighters better financial information with which to make their business decisions.

Improving financial management is the ultimate goal of auditing the financial statements. But the road to an unqualified opinion is often rocky. Too often organizations and their stakeholders have unrealistic expectations about the results of early audits.

Some of the expectations may derive from the term "audit readiness." When laymen hear the term "audit readiness" they may assume it means an organization is likely to obtain an unqualified opinion on its financial statements. It often means, however, that the organization simply has enough evidence ready to subject to the scrutiny of auditors, even though the result may be a qualified opinion or even a disclaimer.

The past has shown that receiving a qualified opinion or disclaimer is often the first step most Federal agencies have had to take before they really understand where the focus of their audit remediation efforts need to be.

Like almost every action DOD takes, its audit will be the single largest audit every undertaken. In addition to large, the audit will be complex because DOD's operations span our Nation's history, while the focus on audit readiness is relatively recent.

Unlike most companies undergoing an audit for the first time, DOD isn't audit-ready. The difference between the initial audit readiness of DOD and most large companies stem from the drive for profit. The profit drive ingrains in private sector personnel that without financial managers' input to keep business decisions, they don't have adequate understanding of the availability of resources to carry out their operations. That nature hasn't been part of the Government's way of doing business. They just assume the funding will come.

While changing today's past practices are slow, the financial statements still reflect transactions from the past. So often obtaining that clean opinion for the first few years is unrealistic. Just as expectations of audit readiness should be managed, it should also

be ensured that realistic deadlines are imposed. In a publicly traded company, auditors are in an organization every quarter and then they have 90 days at the end of the fiscal year to complete the financial statement audit.

Within the Federal Government, agencies have up to 45 days after the end of the year to complete and submit their audited statements to OMB [Office of Management and Budget]. In my view, it is simply impractical to subject an organization as complex as DOD to this unreasonable deadline for the first few years that they are subjected to the audit, especially when the publicly traded counterparts that are smaller and less complex have twice as long to accomplish the same tasks.

Another challenge is DOD's reliance on a complex web of service providers. Service providers perform financial management functions such as transaction processing and systems maintenance. In carrying out the functions, DOD agencies assume the service providers have proper internal controls, while service providers rightly assume that the policies and procedures are residing within the agencies.

An effective manner for DOD to actually gain that assurance, instead of having to assume, is to have the service provider's internal controls audited by an independent party. But it might surprise the Panel members to know that DOD service providers aren't subjected to that audit, like the service providers in other agencies.

In addition, DOD agencies and service providers need a detailed agreement that documents what the service providers are supposed to do for the agencies. That lack of agreement results in poor controls and injects risk in every transaction.

Internal controls within DOD agencies themselves are also weak, and it is another challenge that they face. The organization as large and complex as DOD, they need a uniform approach to internal controls that would greatly enhance their financial management. The DOD controls environment is often far from standard, resulting in a decentralized, ineffective financial management environment. Without a uniform approach, it is difficult to share and adopt lessons learned in all DOD agencies and service providers.

The 2,200-plus business systems that DOD relies on to perform its financial management is another challenge. This would be difficult enough were such systems under some standardization. Unfortunately, consistent policies on data processing and management are not in place.

In my view, there are situations where DOD should not go back and undo the sins of the past. When a proper justification can be made, certain old transactions recorded in a financial system would far outweigh their benefits. But standards and policies and procedures need to be in place to govern systems and the data that they maintain for current and future transactions.

Human capital is another major challenge throughout the Federal Government. The chain of command in the defense community adds complexity to that challenge. Financial management officials at headquarters often have no indirect or no authority over the financial management officials in the field. In addition, those field managers have more loyalty to their commanders than to the headquarters-level staff. This lack of financial management chain-of-

command makes it difficult to apply consistent financial management policies and procedures.

I have discussed the challenges to audit readiness as requested. And though they are many, the talent and energy being invested by DOD in improved financial management is unprecedented. With DOD's continued leadership and attention, and the support and pressure applied by panels such as this one, I am sure we will be soon be reminiscing about just how steep the climb was at one time.

That concludes my opening statement. I would be happy to take any questions.

[The prepared statement of Ms. Porter can be found in the Appendix on page 37.]

Mr. CONAWAY. Thank you, Ms. Porter.

Mr. Keeley.

**STATEMENT OF MARK KEELEY, PARTNER,
PRICEWATERHOUSECOOPERS LLP**

Mr. KEELEY. Chairman Conaway, Ranking Member Andrews and members of the Panel, it is a pleasure to be here today to share my perspectives about the impediments to the Department of Defense achieving audit readiness and the actions the DOD needs to take to become audit-ready.

My own audit readiness perspectives come from 27 years of public accounting experience as a licensed CPA, including 20 years in the private sector and 7 years working here with the DOD. My experience is primarily in information systems auditing, but I will also offer an informed opinion today to the extent that I am able on broad audit readiness matters within the DOD.

The firm in which I am a partner, PricewaterhouseCoopers LLP, has performed first-time audits of several Federal Government departments and DOD entities, including the financial statement audit of the United States Army Corps of Engineers-Civil Works; the financial statement audit of an intelligence community agency; and the service organization audit of the Defense Information Systems Agency.

In addition, PwC [PricewaterhouseCoopers LLP] has been providing audit readiness advice to the Office of the Under Secretary of Defense Comptroller, Financial Improvement and Audit Readiness Directorate, FIAR, for the past 3 years. In this capacity, I have assisted with the development and implementation of the FIAR guidance and helped develop and teach the FIAR Directorate's 3-day audit readiness professional development course to over 1,000 DOD professionals, including financial leaders.

Most recently, I signed the unqualified examination opinion on the successful audit readiness of the Air Force fund balance with Treasury reconciliation process.

As I was preparing my testimony today, I happened to visit the Department of Energy. The lobby of the Department headquarters contains a prominent display about the Manhattan Project and the role of Albert Einstein. The display reminded me of a quotation by Albert Einstein that is relevant to today's topic: "We cannot solve the problems by using the same kind of thinking we used when we created the problems."

The DOD did not intend to create the audit readiness challenges it has today. Rather, the DOD developed and implemented processes and systems tailored to achieve its overall functional mission. Audit-readiness then became an imperative. Because of DOD's incumbent processes and systems were not originally designed to meet audit readiness, a new kind of thinking will be required for the DOD to address the requirements of an audit-ready organization.

Since the CFO Act was passed in 1990, one of the most significant changes in audit readiness thinking that has already occurred in the DOD is the development and implementation of a financial improvement and audit readiness strategy. Rather than attempt to audit an entire component all at once, the strategy prioritizes financial improvement work into manageable waves of audit activity such as the statement of budgetary resources.

The work ethic of DOD personnel is strong and the DOD can accomplish any goal that it sets for itself. The 60-day SBR [statement of budgetary resources] plans that are currently being developed by each component will soon provide detailed blueprints for how the DOD will meet the latest audit readiness deadlines.

Based on PwC's experience, the DOD should continue to improve its financial management and audit readiness efforts in three ways. First, enhance the skills of personnel resources through the addition of certified public accountants who have financial statement audit experience, and also continue to implement the Secretary of Defense Comptroller's financial improvement and audit readiness professional development program, as well as the financial management certification program.

Number two—ensure that functional leaders and financial leaders throughout the DOD, including the leaders of components, as well as shared service organizations, are held equally accountable for audit readiness. Third, ensure legacy or ERP systems are configured to report data in the financial statements as prescribed by generally accepted accounting principles, or GAAP.

I would be pleased to expand further on these three main areas during the question and answer period, and I thank you again for the opportunity to share my perspectives.

[The prepared statement of Mr. Keeley can be found in the Appendix on page 49.]

Mr. CONAWAY. Well, thank you very much. It does occur to me that this may be one of the few times we have five CPAs—there may be some in the audience as well. Any CPAs in the audience? Wow—seven. Steve and I are CPAs as well. So I want to get that on there—just a personal plug.

[Laughter.]

And I am wearing my CPA cufflinks, too, by the way. Rob.

Mr. ANDREWS. I have my American flag cufflinks.

Mr. CONAWAY. Okay.

[Laughter.]

Todd, you have 5 minutes.

Mr. YOUNG. Well, I am not a CPA, so I didn't understand all the CPA humor, but I appreciate everyone being here this morning. I was particularly interested, Ms. Porter, in your comments related to internal controls and the internal control environment within

DOD, but also outside the various stakeholders and service providers that DOD has. I don't know how many entities provide services to DOD, but quite a large number, I suspect.

To your knowledge, are any of those audited with respect to their internal control processes and procedures right now—something that you recommended we start doing?

Ms. PORTER. Within DOD, there are two, I believe, current—they are called SAS-70 or SSAE-16 audits. They are the audits of the internal controls of the service providers. I believe DISA has one and DFAS [Defense Finance and Accounting Services] has an audit, but not as a service provider. There was one more. It might be DCA [Defense Commissary Agency].

Mr. YOUNG. That is all right.

Ms. PORTER. DCIPS [Defense Civilian Intelligence Personnel System] also has one.

Mr. YOUNG. If I understood in your testimony, you actually think that we should engage in more audits, broader audits, more regular audits of those entities.

Ms. PORTER. Of the service providers, yes.

Mr. YOUNG. That would seem to result in a great expansion of all the audit activity of DOD, which may well be justified. It may be necessary, to your mind.

Are there some examples you can think of where had we conducted audits of these service providers, it would have mitigated some challenges that we are now experiencing?

Ms. PORTER. The service providers operate the systems that cut across all the military departments. So I will give you an example. In the Marine Corps, DFAS actually processes the transactions for the United States Marine Corps out of one of their locations. A lot of the information that and the challenges that occur during that audit, DFAS is taking those lessons learned and moving them across the rest of their organization. Had those audits of that service provider happened prior to the Marine Corps audit, there would have been a more consistent and advanced notice of those types of improvements that needed to be made before the Marine Corps audit got underway.

The other part to think about is each time that a service provider—so let us say that the Army goes under audit tomorrow. DFAS still has to be audited by the Army auditors as well because there is not this independent report that each of the auditors of the military services can look at and rely on.

Mr. YOUNG. I see. Okay.

You also spoke, Ms. Porter, to some unique human-capital challenges that our Armed Services face in light of the formal chain of command and then their duties, which are within the realm, in some cases, of financial management; so some people following the marching orders of those in the field, others listening to those at command. That seems like a pretty great challenge. Is that unique, however, to the military?

I mean, within the private sector we have business units, and we have, you know, all sorts of different boxes and different people to look to.

I guess I am trying to get a sense of why this is a unique challenge to the military? Maybe you could speak to that. If I under-

stand the problem maybe we can come up with a better way to address it.

Ms. PORTER. I think the problem is unique to the military because the functional leaders, both at the command level—don't understand how they actually play into the overall financial management role. They don't understand how what they do in making their purchases and the acceptance of—like a receiving report at the field level really has an overall implication up to the financial statements themselves.

And I think that—you know, the command level financial managers understand there is a standard set of policies and procedures. But what happens when they are down there is they get implemented in a way that works for them, which isn't necessarily the standardization across all the Department.

Mr. YOUNG. It seems like that challenge could be one experienced by private sector entities, though, right? And if so, how is it typically addressed there?

Ms. PORTER. I think the challenge could be addressed there, but it is mitigated because the auditors are in with all parts of the organization and have been for years. So everybody understands their role and what they do to get to those audited numbers. And right now this is all foreign to DOD.

Mr. YOUNG. Okay. Thank you.

Mr. CONAWAY. Mr. Andrews.

Mr. ANDREWS. Thank you.

I thank the witnesses.

Mr. Keeley, you tell a story in your testimony about a payroll audit requiring 8,000 hours in 1 year and then 400 hours the next year because of technological improvements that were made. And that is in the context of your assessment of the ERP situation generally.

Given what you know about the progress or lack thereof of the ERP systems, how do you think we are doing? And what suggestions might you make for us to expedite the process and improve the quality?

Mr. KEELEY. Thank you for the question, Congressman.

From my perspective, auditors are systems agnostic. So the FIAR guide itself speaks to the need for the components to improve, legacy systems or ERP solutions.

So the aspects that an auditor looks for in any system is that the transactions are processed in accordance with GAAP, they capture and retain the transaction data so that it can be traced to the financial statements, and that transactions are maintained in a reliable computer environment.

The example I used in my written testimony regarding the 8,000 hours that it took to test the 800 items really comes from the spectrum of control that we need to achieve within the systems environment, both legacy systems and the ERP.

And I have spoken to this point many times at the FIAR directorate and elsewhere throughout the components. Based on all my years as a systems auditor, the controls that are most required for an information system are logical security and programming.

If a component can prove to me that direct access to programs and data is well-secured, that component is well on its way to achieving at least some reliance on—

Mr. ANDREWS. Based upon your knowledge of the ERPs that are in various stages of development, how do we stack up against that criterion?

Mr. KEELEY. My experience looking at the criteria is that the ERPs are first focused on functionality. So it is perfectly normal when you develop an ERP system to make sure it works. That is what the Department of Defense has been primarily focused on.

From my experience, the controls that I spoke to in terms of logical security and program are often implemented after the functionality is addressed. So from my perspective, the view of controls and the testing of logical security programming and operations needs to happen much more quickly. It should be happening at the front end, in the middle and at the end. From what I have seen, that is not happening.

Mr. ANDREWS. Now, Ms. Porter, you make reference to the SSAE-16 standards, which I think you say are lacking in a lot of the service provider areas.

What kind of changes would the service providers have to adopt in order to comply with the SSAE-16 standards?

Ms. PORTER. The first step in the process would be to actually have those systems and their processes as a service provider be examined under those standards.

Right now there is very few, there is one that was recently awarded that is under way right now in the civilian pay process. But that would be the first step.

Mr. ANDREWS. What do think that those examinations would likely yield? And what changes would those examinations likely provoke?

Ms. PORTER. They would yield where there are deficiencies in the controls around the information systems and the transaction processing that those systems take place.

And the hopeful result that would come out of that would be there would be changes made to those systems that would have an impact across all the military services and would get them one step closer to having that production of data at the transaction level—

Mr. ANDREWS. You think those changes could likely be achieved with existing resources or would they require new resources for those service providers?

Ms. PORTER. I think with the proper level of understanding and training, I think they could be accomplished with the service providers that are in place today.

I think they are definitely dedicated to making those things happen.

Mr. ANDREWS. We think so too. We are encouraged by it.

Now, Ms. Boutelle, you sat on both sides of the equation here, in your service, within the Department of Defense as well as on the outside. And you claim, and I think you are right, that increasing the number of CPAs that we have is an essential priority.

Do you think that we have a compensation structure within the Federal service that will facilitate that goal, or won't it?

Ms. BOUTELLE. I think the compensation structure is fine. There is a lot of opportunities to incentivize people to come on board.

So I think if they take advantage of what is available to them to actually target CPAs, perhaps sign-up bonuses, training opportunities and things like that, I think that they can attract strong CPAs into the workforces.

Mr. ANDREWS. We have attracted seven of them here this morning, so that is a very good sign.

[Laughter.]

I also just wanted to comment about the ERPs that—and I want to thank the chairman and Chairman McKeon and Ranking Member Smith in response to our last hearing about some concerns that GAO had raised about the ERPs.

Chairman Conaway and the other members I mentioned, along with myself, signed a letter November 8th to the GAO asking that the GAO update its work on the ERPs by the 31st of December if they could.

So what deadline are we using?

Mr. FODERARO. The 31st of March.

Mr. ANDREWS. I am sorry, I am always an optimist. So that we would have available to us their work; so as we deliberate on the fiscal year 2013 bill we have that. So I wanted to thank the chairman for his cooperation in that letter, and thank you for writing it.

[Laughter.]

Thank you very much.

Mr. CONAWAY. Thanks, Rob.

Steve.

Mr. PALAZZO. Well, good morning.

And for Todd, I am not going to say any CPA jokes, because he just doesn't get our humor.

[Laughter.]

And I guess we will just start with Ms. Boutelle and just go to the right.

I am interested in knowing—I was going to talk about ERPs. And as a CPA myself I have been through the ERP process; not at the level of a DOD audit. So I was going to talk on that.

But what I wanted to see is—you know, there have been some dates out there. We are supposed to achieve audit readiness by 2017. Then all of a sudden Secretary Panetta came out and said, "We can do this by 2014." Then all of a sudden there is some—you know, there was an article—for another \$1 billion we could do it by 2017.

So in you all's opinion, what is a true, accurate date? You know, where do you think we are actually going to be able to achieve audit readiness? What are some of the most important factors in preparing us for audit achievability and any weaknesses and strengths along the way?

And you can expand or summarize however you want.

Ms. BOUTELLE. Good question. That is a question that has been asked for years, right? And I think that until the business leaders become more engaged in fixing the business processes and systems that the progress is not going to be made as aggressively as it needs to.

So to the point of what needs to be done, besides leadership involvement, I think there is something to be said for the ERPs, but to build the ERPs off of standard processes, standard data, they need to focus more on the business enterprise architecture in the Department, a wonderful tool that would allow them to build the processes so that there is one place of truth for how to do business with the Department—or within the Department—and would allow them then to test all of the ERPs that are being developed against that one standard truth.

So I think that that would certainly help. But I do think that the biggest challenge is getting the owners of the processes. So, again, whether you are talking about a payroll transaction, you are talking about receiving goods or services, you are talking about issuing inventory, transporting equipment material, all of those are business processes and those transactions are the type of transactions where the impediments are.

And so to fix them, to meet audit criteria, is what should be the major focus going on in the Department.

Mr. PALAZZO. Just real quickly: 2017 or 2014—

Ms. BOUTELLE. So—

Mr. PALAZZO [continuing]. Or somewhere in between?

Ms. BOUTELLE. So I actually think 2014 is very aggressive. I just think that is very aggressive given all of the details that they need to work.

But somewhere between 2014 and 2017, I think, should be doable if they put the resources and the attention on it that is needed.

Mr. PALAZZO. Thank you.

Ms. Porter.

Ms. PORTER. I would agree with Ms. Boutelle that you need that sustained leadership to continue and you need that leadership to get out to the field level so that they really do understand what their role is in the overall financial management process.

The other thing I think that is going to be key to this is transaction level detail, regardless of where that transaction level detail comes from—because you can't do an audit without it. And the other thing that you need is the documentation that is going to support the transaction level detail.

If you put all of those things together, you can achieve the 2014 and the 2017 goal with the right amount of focus and the right sustainment across the Department.

Mr. KEELEY. Congressman, I have two points to make on this topic.

From my perspective, the first one is methodology. In order to achieve the date, the methodology has to be ingrained throughout the Department. In the FIAR methodology, it is very straightforward and basic. We need to identify and document financial processes, test internal controls, test documentation, find gaps and correct them.

The most important aspect right now is testing. We have spent a lot of time documenting processes. And I have seen volumes of them. And people are documenting everything they do that is critical to the mission, and that is very important.

We need to extract the financial aspects and get down to testing. That is my first point.

The second point I would mention is the skill of the people to apply this approach. People are definitely hard-working; and there is a strong work ethic throughout DOD. But it comes down to judgment. When you look at workarounds in an ERP solution, how you are going to test that workaround. It comes down to pure judgment, and that only comes from experience.

The word “judgment” appears in the Government Accountability Office financial audit manual and the yellow book of Government and audit standards 270 times out of 1,300 pages.

So judgment is critical to being able to test and execute and achieve the 2014 date.

Mr. PALAZZO. I am out of time. I yield back.

Mr. CONAWAY. All right. Thanks.

Ms. Porter, you mentioned the—to flesh out, just for the record, the impact of having the service providers be audited by each of the—because the service providers don’t have their own audit that other accountants can rely upon, each of the various entities would in effect have to come in and audit that service provider itself.

Can you walk us through why it would be less expensive audit-hour-wise and cost to the taxpayer if those service providers had documentation audits that they could give to the various branches and other components that the auditors there could rely on?

Ms. PORTER. What that means is that, if those independent-service-provider audits are available, the auditors of the statements themselves of the service organizations could rely on that work. There would only be—as long as that service provider audit covered the right period of time.

So I will give you an example for the Marine Corps. If DFAS had had a service-provider audit that covered the last 9 months of the fiscal year, we would not have had to go in to the DFAS to look at their controls or look at the controls of the systems that they operate, such as the defense civilian pay system or the defense cash accountability system.

Instead, we could have used the audit of that service provider and relied upon that report. That is assuming that that service provider’s report was an unqualified opinion or that it identified where the weaknesses were, because then what that would allow us to do is then focus back into the Department what were the mitigating controls that they had in place to compensate for the weaknesses of the service provider.

Mr. CONAWAY. Mr. Keeley, you mentioned the other day, in a conversation that we had—or today, in fact—that you are “systems-agnostic.” That was your phrase.

Flesh that out. In the sense of you can audit, if the controls are there, no matter what the system, whether it is an ERP or a hand-posted set of books, if the controls are there, you can audit that.

Would you, kind of, walk us through what you meant by that?

Mr. KEELEY. Yes. The controls need to be there. What we often find—and I will use an example of what I have seen in the field—is the earlier testimony you have received about ERPs talks about 2,200 or so systems throughout the DOD.

Now, auditors are not afraid of size. So we can go in and look at the systems that need to be audited. But one aspect of the ERP solutions is to consolidate the data so that you don't have duplication of data.

One area of systems that causes a great deal of problem in an audit, when you have data in duplicate systems, an auditor doesn't know which to choose. And so, in working with business folks, if the business folks have data in a legacy system and an ERP system, it is difficult to first reconcile that information and then nail down a population.

We spend a great deal of time identifying the absolute population upon which we can test. And if we can't identify the population, we cannot move forward.

So, less may be more in the case of the ERP consolidation; so I applaud the effort. But that is much more of a business decision. I do not want an audit to impede the DOD's warfighting mission. If you need 2,000 systems to achieve the mission, I can audit it.

So it is a matter of determining how much reliance I can place on that system.

And the financial information systems audit manual has 424 points to it. We all, as auditors, apply judgment to those points and we can address primarily half of them to get you to at least some reliance on internal controls and be much more efficient using judgment.

Mr. CONAWAY. That reliance on internal controls, just for the record, drove the drop in audit hours from 8,000 audit hours to 400 audit hours in that previous example.

Mr. KEELEY. That is a perfect example. If we go from no reliance on a system, because, for instance, if security is not locked down, to at least some reliance, the change in substantive testing is exponential.

Mr. CONAWAY. All right.

Ms. Boutelle, based on your experience, we talk about the workforce and the need for CPAs with a specific background in either financial statement audit or financial statement preparations. We have got a lot of folks, CPAs, in the system now.

Is it all or none? Do you have to hire these folks from the outside totally, or can you cross-train or retrain or help get experience for the folks who are already on the team who know the way that these are going on, to help get them the skills necessary to be able to fill some of those slots that are lacking?

Ms. BOUTELLE. So I think that they could work side by side with trained audit professionals. I think that the three firms here at the table have people on board helping in different places in DOD. I think, if they paired up some of their CPAs with the folks working audit readiness or even the audits, and they worked closely and they had a defined approach for how they would do that, I think that the experience gained by the current CPAs in the Government—that would enhance their capability to help the Department move forward.

I do think that—you know, I am a CPA having spent most of my time in the Government. And I am not as proficient in audit as these two colleagues next to me. You know, I have lots of wonderful

audit practitioners back at Deloitte that I have learned a lot from in the 7 years that I have been there.

So I do think that bringing in more seasoned audit practitioners to help guide the approach and then letting the folks within the Government learn from them would be a doable approach.

Mr. CONAWAY. Thanks.

We are going to have time for another round. Rob?

Mr. ANDREWS. I really don't have another round of questions at this time.

Mr. CONAWAY. Okay.

Todd, Scott, or Steve?

Ms. Porter, the real-world example you were giving us about publicly held companies provide, or produce quarterly financial statements, and your firm is in their shop—well, some level of engagement with those quarterly reports.

But that is not happening in the Federal—is there a similar process that could go on in the Department of Defense, in this example, that would shorten the timeframe needed to close out the books in November? I mean is there a way to look at what you do in the private sector with those quarterly reviews that you do and the impact it has on the year-end audits? Could that same model work in some altered form in a Federal agency?

Ms. PORTER. Well, first, let me say I am not advocating quarterly reports for the Federal Government. I really don't want to be on the record of saying that because everyone will—

[Laughter.]

Mr. CONAWAY. That was not—

[Laughter.]

Ms. PORTER. Yes. But what I think that does is it adds a discipline and an exposure to the auditors that the DOD hasn't experienced so far because they are in there having the conversations. They are having discussions around what are your management controls that you use?

And this is where it is not the auditors that are driving what the civilian agencies or even the commercial entities are doing. Management understands what they need to operate their business from a control perspective. And the auditors figure out how to use that information to get what they need to conduct the audit, to give management the feedback back as to whether they are using accurate financial information to make their decisions.

It has been, from a DOD and a Government perspective, for years, but proprietary accounts weren't looked at. They only focused on the budgetary sides of the transactions. And that was often driven by what overseers were asking them to report back up on.

So as they have tried to get themselves in tune to both sides of the transactions, the budgetary and the proprietary side, there has been a learning curve. And sometimes that learning curve has been impeded by not having the true understanding of what level of detail, what an auditor actually looks for, and they don't have that in the commercial entities because they are so involved with each other all the time.

Mr. CONAWAY. All right. Mr. Keeley, any comments in regard to that?

Mr. KEELEY. No. Are you—

Mr. CONAWAY. Well, just that, you know, field work being done more regularly throughout the year—would that reduce the number of total audit hours?

One of the things we are obviously going to—at some point in time, get to a running rate in which the controls are in place; the systems are working and sustainability of the audits year in and year out is going to be the key.

That first audit, you can't maintain the level of intensity to get to that first audit year after year after year after year, I don't think.

Once you have got this thing running, what would be the role of the auditors during the normal process?

Mr. KEELEY. Well, yes, Congressman, my view is that continuous auditing has always been a bit of an enigma, even in the private sector. Yes, auditors are in the field, and we can do early substantive testing.

But from my experience in the private sector 7 years before I came down here, the private-sector companies have teams of specialized accountants. They have tax departments with tax accountants. They have statutory accountants focused on compliance reporting. And then they have GAAP accountants.

So they have entire teams in the field supplemented, of course, with internal audit. And they work at the companies. They are the companies' employees.

Our auditors, to the extent we can interact with them throughout the year and actually perform the testing I was talking about, definitely expedites the audit.

There are accounting standards and rules that allow us to perform early testing and still rely on it for the year end.

So it is definitely difficult to do, but it is done throughout the community.

Mr. CONAWAY. Ms. Boutelle—I have got one more question for Ms. Porter—but, first, Ms. Boutelle, given your experience in both sides of the shop, is there a way to create a chain-of-command responsibility at Department of Defense, other than have whoever the current Secretary of Defense is saying, day after day after day, get this done—in other words, can there. You know, Bob Hale has, or the Assistant Secretary of State—Comptroller really doesn't have command reach into all these other places.

So, given that org chart that is in place—and we are going to make a lot of changes to it—is there a way that we can get to a point or a system that holds all the folks at the various levels accountable for making sure this gets done, so that—any thoughts on that?

Ms. BOUTELLE. I think, with the Secretary's involvement and whoever the Secretary is, going forward, has to be involved. I think that that will send a very strong message.

Now, I understand that the reality is that the Secretary is not going to meet with the business owners on a monthly basis, most likely, but some periodic forum would be beneficial.

The Chief Management Officer and the Deputy Chief Management Officer, I think, having responsibility for the business processes, the systems, would also be a very strong marriage between

those two roles, the CMO and the DCMO, with Bob Hale in driving this, that maybe between the two of them—I know Beth McGrath has got tremendous knowledge of the systems and the processes.

I think coming together with Bob Hale they make a pretty formidable team. They have got to have the power, though, to direct changes within the business areas. And without that, they cannot be as successful as they need to be.

Mr. CONAWAY. Ms. Porter, I can't let you off the hook. What can you share with us, if anything, about the Marine Corps audit that—and you may not be able to talk to us about this year's Marine Corps audit, but can you share with us a perspective on the difference between where the Marine Corps was this time last year and where the Marine Corps is today, without telegraphing too much what is going to happen shortly? I couldn't let you off the hook.

Ms. PORTER. Sure.

So last year's audit, in fiscal year 2010, we had a big struggle at the beginning of the audit. We didn't get very far into the testing beyond beginning balances. We basically tested no current year transactions.

For the fiscal year 2011 audit—well, let me go back to fiscal year 2010. There were also quite a few findings and recommendations that came out of the audit that the Marine Corps started immediately to undertake remediation actions to while the audit was still under way.

In fiscal year 2011, you could see that there was an improvement in the process, they better understood what we were looking for, they were better able to produce reconciliations and tie-outs of data that we had a big struggle with in the previous year. It is not perfect because they still had some struggles this year. We thought it might be a little bit better. But they are moving in the right direction.

We have also got to a lot more current year testing this year than we did in the past. So you definitely see that they are becoming more accustomed to understanding what we are looking for. We are also becoming more accustomed to how they do business and what documentation they have.

And so I see progress every year. And I also see them taking those lessons learned to the other Services.

Mr. CONAWAY. All right. Typically, you know, in a commercial entity you give a set of financial statements. You also give them a statement of weakness of internal controls—did you see adequate remediation for the stuff that you discovered in the 2010 audit, Marine Corps make—without specific details—but make adequate process at addressing those weaknesses and moving as far as you thought they could move in the time they had to move it?

Ms. PORTER. We issued two different sets of findings and recommendations to the Marine Corps last year, one associated with information technology and one associated with the financial statement controls themselves.

So the information technology piece, we did see quite a bit of changes and were able to test those actions that they took last year. And before we had to cut off testing I would say there was probably another 20 to 30 percent of them that are ready to be

tested right now, that the action actually took place after we stopped testing.

For the financial statement findings, it is a little more difficult to address because we haven't yet been able to conduct the test of the current year transactions, which—associated with those findings—which would actually in fact tell us whether the remediation actions worked.

Mr. CONAWAY. All right. Okay.

Rob, other questions?

Mr. ANDREWS. Well, just as a concluding comment, think Ms. Porter's limited sneak preview of the Marine Corps audit, which shows reason for optimism. And the chairman's question about sustaining the progress we have made beyond this Secretary of Defense I think is the core challenge facing this panel.

I think Secretary Panetta deserves enormous praise for giving this effort such a high priority. But there will be another Secretary of Defense soon. There always is.

Mr. CONAWAY. Maybe even another president.

Mr. ANDREWS. Maybe. That is right. And whether there is another president or this one, there is—you know, secretaries do change.

And I do think that our key mission is to try to build into the culture of the institution and the structure of the institution a high priority on this audit readiness, because if we have to rely upon the leadership priorities of the person who is going to be secretary, I just don't think we are ever going to achieve what we need to do, because, you know, priorities come and go.

So the chairman and I have talked about this before. Think all members of the Panel and members of the public should be thinking about advice they could give us on institutionalizing the progress that we have seen right now.

I think very much of that is attributable to the chairman's focus, laser-like focus on this issue for several years, and on Secretary Panetta's admirable response to that. But we want to make this a principle that extends beyond individuals to a more embedded culture in the organization. However we can do that, I think we will have made great progress.

And I do appreciate the contribution of the three witnesses here this morning. Thank you.

Mr. CONAWAY. Well, I want to echo Rob's praise of Secretary Panetta, unprecedented forward leap and commitment to this issue. And I am really tickled to death he has made that.

Just quickly, just kind of maybe a yes or no, have we got enough forward momentum toward this goal that this is actually going to happen? In other words, can we—we get beyond that tipping point where, yes, it is going to be heard, and, yes, it may take a while, but have we got past that point where we really are going to make this happen, in your all's perspective?

Mark.

Mr. KEELEY. Yes, sir, I believe so. One of the topics I talked about in my testimony was the lessons learned. So we have a great deal of lessons learned from the Marine Corps, from the Army Corps, from DISA and others. And we are always looking back at those lessons and applying them going forward.

So applying the lessons and speeding the training and momentum is certainly achievable.

Mr. CONAWAY. Okay.

Tracy, your perspective?

Ms. PORTER. I do think the goals are there. I think the sustainment across the Department at the lower levels so that it doesn't go away when the Secretary changes is critical to make this leap forward that they are trying to get to.

So with that right amount of focus and with those lessons continuing to being learned and nobody backing off from that progress and just keeping that pressure on, because you take the pressure of the audit readiness or the pressure of the audit off, the way things work right now aren't yet well ingrained in everybody within the Services. So they will immediately fall back to their old way of doing business.

So you have to just keep this pressure and this momentum in order to keep us going in the direction that they need to go.

Mr. CONAWAY. JoAnn, your comments?

Ms. BOUTELLE. I agree with Ms. Porter. I think that you have to keep the pressure on. I think that the momentum is there, it is moving, you have brought tremendous attention to this topic. But there is a ways for them to go for the business owners to truly embrace and understand their responsibility.

So, again, I think that they can make it if you keep the pressure on them.

Mr. CONAWAY. All right.

Well, thank you three. I appreciate the witnesses today. And we did not telegraph that question. We try to make sure this panel keeps existing. No.

[Laughter.]

One of our big issues is how do we put in place the right kind of attention at the committee so that when Rob and I are doing something else or going somewhere else, that pressure and that commitment from our side on the oversight piece remains in place in the appropriate manner to make sure we do our part of that.

Again, thank the witnesses for being here this morning.

We are adjourned.

[Whereupon, at 8:56 a.m., the panel was adjourned.]

A P P E N D I X

NOVEMBER 17, 2011

PREPARED STATEMENTS SUBMITTED FOR THE RECORD

NOVEMBER 17, 2011

Statement of Hon. K. Michael Conaway
Chairman, Panel on Defense Financial Management and
Auditability Reform
Hearing on
Industry Perspectives on Achieving Audit Readiness
November 17, 2011

I'd like to welcome everyone to today's hearing on Industry Perspectives on Achieving Audit Readiness. Over the past 4 months, we have heard from a variety of witnesses within Government, including representatives from the offices of the OSD and Military Department Comptrollers, the DOD functional communities, the DOD Office of Inspector General (OIG), and the GAO on the challenges the Department faces in achieving audit readiness and its efforts to resolve these issues. Today, as the Panel nears the completion of its work, we turn to accounting firms that have experience out in the private sector, as well as within Government, to get their views on the impediments to DOD achieving auditability and the actions needed to address these challenges.

In addition to having experience performing work at various other entities, these firms are involved in almost every aspect of DOD's financial improvement and audit readiness (FIAR) effort, ranging from assisting DOD components in implementing the FIAR strategy, to assisting the Office of the Under Secretary of Defense (Comptroller) in performing its review of the DOD components' progress, to actually performing certain audits themselves. Therefore, they can provide a well informed point of view on the problems facing DOD as it works towards achieving auditability on the Statement of Budgetary Resources by 2014 and the full set of financial statements by 2017.

Some of the challenges that have been identified to date include sustaining leadership and effective oversight, ensuring workforce competency, implementing Enterprise Resource Planning (ERP) systems, resolving long-standing internal control weaknesses, and managing organizational challenges associated with having a large and complex organization such as DOD. The witnesses here today may or may not consider all of these issues as impediments to improving financial management and achieving audit readiness, or they may have a slightly different take on the issues, or they may identify different challenges all together. Most significantly, they may be able to provide alternative options on how to overcome these weaknesses. That is why I look forward to hearing their expert views on the issues confronting DOD and possible courses of action to address these challenges.

I would like to thank our witnesses in advance for their testimony and agreeing to be with us this morning. We have with us today:

- Ms. JoAnn Boutelle, Partner, Deloitte & Touche LLP;
- Ms. Tracy Porter, Partner, Grant Thornton LLP; and
- Mr. Mark Keeley, Partner, PricewaterhouseCoopers LLP.

**Written Testimony of JoAnn Boutelle
Partner, Deloitte & Touche LLP**

November 17, 2011

Chairman Conaway, Congressman Andrews, and Members of the Panel, thank you for the opportunity to testify today concerning industry's perspective on achieving audit readiness at the Department of Defense (DOD).

I have had the unique experience over the last 26 years serving in both government and now industry to help organizations navigate their way through the most complex auditing and financial management challenges. For the past seven years, I have been at Deloitte working side by side with audit and consulting professionals, expanding my knowledge of best practices in the audit and financial management areas.

Deloitte LLP and its subsidiaries have more than 50,000 employees working from 89 U.S. cities, providing audit, tax, financial advisory and consulting services to commercial and government clients. Deloitte's Federal Practice, consisting of over 6,500 professionals, has been providing audit readiness support to the Army, Air Force, Navy and other parts of DoD.

Prior to joining Deloitte, I worked as the Deputy Chief Financial Officer (DCFO) at DoD for over two years, and prior to that at the Defense Finance & Accounting Service (DFAS). While serving as the Deputy Chief Financial Officer, I constantly challenged the lack of accountability and the need to improve financial statements, business processes, and systems. I worked to implement actions which started the Department on the path towards not only achieving audit readiness but also improving the quality and timeliness of data for the decision makers. Let me share a few examples:

- First, I initiated a requirement for the Components' Financial Managers to brief their financial statements to the DoD CFO twice a year. It turned out to be harder than I thought for the Financial Managers to explain the causes of the changes in the financial information. The Financial Managers and their staff lacked the

understanding of how business events impacted the financial statements. My team at DoD worked collaboratively with the Departments' Financial Managers to educate and train their staff to understand the complexities of the financial statements. Today the Components' Financial Managers are more knowledgeable of the business impacts on the financial statements and are involved in discussions on how to get their organizations ready for a financial statement audit.

- Another example goes to the heart of the challenge DoD leadership is facing around stove-piped systems with unique business processes. There is a lack of standard processes, standard data and effective controls in so many systems. This makes it difficult to compile meaningful data at the DoD enterprise level for Department-wide analysis. It also makes it difficult to determine if the processes and systems are operating in compliance with laws and regulations. To get one authoritative source of the business rules that should be used by the Department, I put in place the business enterprise architecture (BEA). Business rules are critical and should include needed controls, validation edits to ensure integrity of the data, hand-offs between business partners, details of process flow, and data standards. An organization as large and as complex as the DoD needs a BEA so that there is one place to go to, one master architecture, when developing a system of how to do business in and with DoD.
- Last, the Components needed a plan of the deficiencies that would prevent them from obtaining an unqualified audit opinion and associated corrective actions. These were pretty basic plans at the time and did not have all the actions required to identify all the deficiencies. The Components continue to improve on their plans as they gain more knowledge about what is required to complete a financial statement audit.

These were strategic, effective initiatives started when I was at DoD and DoD leaders have continued to improve on them. However, there are two additional areas critical for DoD to achieve an unqualified audit opinion: 1) An increased and sustained commitment from DoD leadership, and 2) a workforce with the applicable financial and technical competencies.

Leadership

A commitment from DoD leadership starting at the Secretary-level is critical to achieve audit readiness by 2017. This belief comes from Deloitte's direct experience working with both commercial and government clients. Over the past decade, Deloitte has helped government agencies successfully transition from an unauditible to an auditible state. In the commercial audit space, we worked closely with companies as they strived to transform their organizations to comply with the Sarbanes Oxley Act of 2002, or reconstruct their financial statements following bankruptcy or fraud. In each of these experiences, the common thread that helped them succeed was dedicated leadership and a commitment from the top to meet tangible milestones.

While commercial organizations from the CEO and COO levels drive initiatives to fix processes and tighten controls, DoD lacked the commitment to devote the level of time and resources necessary to achieve audit readiness. Secretary Panetta's recent announcement that he is now personally involved in driving the Department to achieve audit readiness is a major signal that this is a top priority for the Department.

For the past 9 years, the Chief Financial Officer, his staff, and the financial management community across the DoD demonstrated leadership in coming together to tackle the tough aspects of fixing their business processes and systems. I commend them for their daily commitment to this effort. However, I believe the responsibility for the controls over assets and compliant reporting of accounting events is the primary responsibility of the business process owners. Business owners within the Department must come together with the financial management community to jointly correct deficiencies that are preventing DoD from becoming audit ready. The Department requires a 100% commitment from all facets of the organization, not just the financial managers. Cross functional ownership at the senior levels cannot be forced by the CFO who is a peer to many of the business leaders. This is a job for the Secretary and the Deputy Secretary and an area for tangible and measurable improvement.

Let me provide an example within DoD where a director of an agency became personally involved in achieving auditability, with results and remediation, leading to significant cost savings. The Defense Information Systems Agency (DISA) started on a journey to obtain an audit opinion on its financial statements in the 2005 timeframe. The DISA director and other DISA leadership were personally involved and actively drove the remediation efforts, resulting in significant cost savings. Deloitte assisted them and it took about three years to identify their audit weaknesses and for DISA leadership to implement corrective actions. In our opinion, the direct and ongoing involvement of DISA senior leaders was a major factor in their success. DISA has just successfully completed a FY2011 Working Capital Fund financial statement audit. In addition to getting their financial house in order, DISA also identified close to \$400M of funds they were unaware were available. This was a major success for the organization – a commitment and investment by the DISA Director and the DISA leadership team to remediate their financials, leading to more efficient and responsible organizational spend.

Deloitte saw similar challenges in recent years on the commercial side of our business where CEOs and COOs had to aggressively lead the implementation of the Sarbanes Oxley Act. Many of our commercial clients were struggling to meet the compliance and reporting demands placed on them by the Act. For many of our clients, achieving compliance with the Act's requirements involved significant transformation of their culture, business practices and systems, and internal controls. These organizations quickly learned that success required the full engagement of chief executives not only in Finance, but also in Operations, Information Systems, Human Resources, and in the business units which were in many cases highly decentralized and global. This pattern of leadership engagement is critical to the Department's ability to meet its aggressive audit readiness timelines.

I believe this Panel can help by reinforcing the need for full engagement, commitment and accountability from Defense leaders across the organization to the Department's audit readiness goals. This means that Departmental Chief Management Officers

(CMOs), Chief Information Officers (CIOs), acquisition leaders, supply and logistics leaders, human capital officers and others must better understand their role in the audit readiness process, and take ownership and accountability for the results. Without this leadership commitment, I do not believe the Department will meet its 2017 goal.

Workforce

Now, let me address the second critical area for success – the need to improve the competencies of the DoD workforce involved in processing the business transactions at the DoD. The financial management staff of the DoD are some of the most dedicated people I have had the honor of working with during my entire work career; but there are many other DoD employees who are equally dedicated in the business units processing transactions. They know their systems and processes and through their efforts, critical supplies and support are provided to the military. However, they also need to ensure the integrity and soundness of the financial data they are creating. This will most effectively be accomplished through established internal controls, compliance with policy and procedures, and more integrated processes.

There is a need to enhance financial controls within the business processes and systems to improve on the accuracy and completeness of data recorded timely into the financial systems. Removing the human element and adding more automation is the most effective and consistent way to add these needed financial controls. There are thousands of people across DoD touching transactions that create financial events. These people do not have to be trained accountants. They need to be trained supply technicians, personnel clerks, or contracting officers – or the various functional technical competencies of their job. They also need to understand their role in financial management.

So what are the skills needed by DoD personnel?

- People who are involved in the financial statement preparation should be CPAs with financial statement audit experience. Increasing the number of CPAs in DoD can be achieved by hiring people who already possess their CPA designation

and incentivizing current employees, who meet the criteria, to take the CPA exam.

- People who process transactions should be trained in accounting controls and processes related to their jobs. The Certified Defense Financial Manager certification provides a foundation of government accounting and controls.
- Leading an audit or audit readiness program requires people with experience in leading financial statement audits. The DoD lacks people with this expertise and where there are gaps, government should rely on industry to support. Getting to the first audit opinion is the most difficult step, and the need for seasoned audit professionals are needed to help DoD focus their resources most effectively.

Conclusion

Government and its industry partners share the same goal. We want to see the Department of Defense achieve an unqualified audit opinion and for them to meet their deadlines. But sometimes, there are elements that impede their ability to get the job done.

How do we overcome them? We do so by focusing on leadership, the financial management competencies needed across the workforce, and a culture of commitment to making the changes necessary to achieve auditability.

The DoD and industry must work together to meet these goals.

I want to thank the Panel for holding a series of hearings on Defense financial management and auditability reform, and for your laser focused attention on this very important issue. Thank you and I look forward to your questions.

Deloitte.



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Ms. Boutelle is the Federal Practice's Partner on the National Chief Financial Officer Program. Until recently, Ms. Boutelle was Deloitte's Lead Client Service Partner for Department of Defense (DoD) Agencies, Joint Commands, and Offices of the Secretary of Defense.

Prior to joining Deloitte, she had a DoD career where she was recognized as a committed leader to reforming business processes and incorporating the accounting, finance and internal control requirements for strong DoD end-to-end business processes. Ms. Boutelle is extremely knowledgeable in the DoD environment and related DoD policies and procedures. She led the DoD Business Management Modernization Program which is by far the largest single transformation project in the world. She has led major business process transformation initiatives for the DoD. While at the Defense Finance and Accounting Service (DFAS) and as Deputy Chief Financial Officer (CFO) for DoD she supported major efforts to implement standard business rules and technology. During her role as Deputy CFO, she was directly responsible for bringing together Government Accountability Office (GAO), Office of Management and Budget (OMB), and DoD Inspector General (IG DoD) to work on a joint effort for improved financial management practices for the DoD.

Ms. Boutelle is a Certified Public Accountant and earned her bachelor's degree in accounting from Indiana University in 1982. She received her master's degree in the management of information technology from George Washington University in 1998. Ms. Boutelle is a graduate of the DoD Senior Executive Leadership Program.

**DISCLOSURE FORM FOR WITNESSES
CONCERNING FEDERAL CONTRACT AND GRANT INFORMATION**

INSTRUCTION TO WITNESSES: Rule 11, clause 2(g)(5), of the Rules of the U.S. House of Representatives for the 112th Congress requires nongovernmental witnesses appearing before House committees to include in their written statements a curriculum vitae and a disclosure of the amount and source of any federal contracts or grants (including subcontracts and subgrants) received during the current and two previous fiscal years either by the witness or by an entity represented by the witness. This form is intended to assist witnesses appearing before the House Armed Services Committee in complying with the House rule.

Witness name: JoAnn Boutelle

Capacity in which appearing: (check one)

Individual

Representative

If appearing in a representative capacity, name of the company, association or other entity being represented: Deloitte & Touche LLP

JoAnn Boutelle is a Partner of Deloitte & Touche LLP, which is a subsidiary of Deloitte LLP. The subsidiaries of Deloitte LLP (which include Deloitte Consulting LLP, Deloitte & Touche LLP, Deloitte Financial Advisory LLP and Deloitte Tax LLP), through each of their federal practices (the "Federal Practices"), collectively perform in excess of \$1 billion annually with the federal government.

The Federal Practices currently support approximately \$300 million annually in prime contracts with the Department of Defense (DOD). Of these, over \$10 million is related to audit readiness services at DOD. Moreover, Deloitte LLP's subsidiaries may plan to pursue future contracts and subcontracts that support or relate to supporting DOD in their efforts to achieve an unqualified audit opinion.

FISCAL YEAR 2011

federal grant(s) / contracts	federal agency	dollar value	subject(s) of contract or grant
N00178-04-D-4020	Navy HQ	\$4,479,082.30	Financial Improvement Program Management
HQ0423-10-F-5002	OSD Comptroller (FIAR)	\$3,069,440.10	FIAR office support
N00033-12-C-8017	Military Sealift Command	\$2,054,426	N-8 audit readiness support
N00178-04-D-4077	Office of Naval Research	\$1,068,313.15	Financial Improvement and Audit Readiness support

FISCAL YEAR 2010

federal grant(s) / contracts	federal agency	dollar value	subject(s) of contract or grant
N00140-05-D-0019	Office of Naval Research	\$2,019,715.44	Financial Improvement and Audit Readiness support

FISCAL YEAR 2009

Federal grant(s) / contracts	federal agency	dollar value	subject(s) of contract or grant
N00140-05-D-0019	Office of Naval Research	\$1,999,835.65	Financial Improvement and Audit Readiness support

Federal Contract Information: If you or the entity you represent before the Committee on Armed Services has contracts (including subcontracts) with the federal government, please provide the following information:

Number of contracts (including subcontracts) with the federal government:

Current fiscal year (2011): _____;
 Fiscal year 2010: _____;
 Fiscal year 2009: _____.

Federal agencies with which federal contracts are held:

Current fiscal year (2011): _____;
 Fiscal year 2010: _____;
 Fiscal year 2009: _____.

List of subjects of federal contract(s) (for example, ship construction, aircraft parts manufacturing, software design, force structure consultant, architecture & engineering services, etc.):

Current fiscal year (2011): _____;
 Fiscal year 2010: _____;
 Fiscal year 2009: _____.

Aggregate dollar value of federal contracts held:

Current fiscal year (2011): _____;

Fiscal year 2010: _____;
Fiscal year 2009: _____.

Federal Grant Information: If you or the entity you represent before the Committee on Armed Services has grants (including subgrants) with the federal government, please provide the following information:

Number of grants (including subgrants) with the federal government:

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.

Federal agencies with which federal grants are held:

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.

List of subjects of federal grants(s) (for example, materials research, sociological study, software design, etc.):

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.

Aggregate dollar value of federal grants held:

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.



Statement of Tracy E. Porter, Partner, Grant Thornton LLP

**Before the House Armed Services Committee Panel on Defense Financial
Management and Auditability Reform**

November 17, 2011

Not for publication until
Released by the
House Armed Services Committee

Chairman Conaway, Ranking Member Andrews and distinguished members of the Panel, good morning and thank you for inviting me to testify today on behalf of Grant Thornton LLP. I applaud this panel's commitment to bringing financial management excellence to the Department of Defense and am pleased to be able to share with you my perspective of the impediments to DOD achieving audit readiness and actions DOD needs to take to become audit ready. Now, I know for some audit readiness at DOD may seem like a struggle that will not soon be won, but in fact there have been many financial management improvements in the Defense community in the 24 years I have been involved with it. In the recent past I have seen significant changes, including a much stronger focus on improving financial management, and not simply because of the audit. Instead, there is a strong and sincere desire at DOD to give Defense managers and warfighters better financial information with which to make important decisions and manage daily affairs. I am impressed by the attention that DOD is giving to internal controls and the Defense community's understanding of their importance to the mission, not just the audit.

Today I will discuss my perspective on the Department's audit readiness challenges, which has been formed as a result of conducting audits and audit readiness engagements for the federal government, as well as for private sector clients and state and local governments. As you may know, Grant Thornton LLP was recently retained to perform an audit of the United States Marine Corps' annual financial statements. The results of that audit are not the subject of my testimony today. Rather, I hope to share with the panel members observations I've made in my many years as a public sector audit professional.

The Chief Financial Officers Act of 1990 first established the requirement that agencies produce audited financial statements. Since that time, most federal agencies have made steady progress producing financial statements, subjecting them to audit, and receiving unqualified opinions from auditors. The Department of Defense is an outlier. GAO recently testified, "Over the years, DOD has initiated several broad-based reform efforts to address its long-standing financial management weaknesses. However, as we have reported, those efforts did not achieve their intended purpose of improving the department's financial management operations."¹

Before discussing the challenges and impediments, I would like to acknowledge the efforts of the Department's senior leadership to reform financial management within the Department. Transforming an entity as large and decentralized as the Department is no easy task, especially when the entity is entrenched in hundreds of years of business that focused on budgetary accounting and not proprietary accounting. The senior leadership of the Department has demonstrated a commitment to improving financial management and taken actions necessary to address the known impediments to improve financial operations.

DOD faces unrealistic expectations

Improving financial management is the ultimate goal of requiring audited financial statements. But the road to an unqualified opinion (often referred to as a clean

¹ Government Accountability Office, *DOD Financial Management: Improved Controls, Processes, and Systems Are Needed for Accurate and Reliable Financial Information*; Report Number GAO-11-933T (Washington, DC, September 23, 2011).

opinion) is often rocky. Too often, organizations and their stakeholders have unrealistic expectations about the results of early audits. Some of these expectations may derive from the term “audit readiness.”

When laymen hear the term audit readiness they may assume it means an organization has sufficiently strong financial management in place that it is likely to obtain an unqualified opinion on its financial statements. It often means, however, that an organization simply has enough evidence ready to subject to the scrutiny of auditors, even though the result may be a qualified opinion or even a disclaimer. And though receiving a qualified opinion or disclaimer may be painful, it is the first step most federal agencies have had to take before substantially improving their financial management operations.

For example, fewer than half of the major federal departments and agencies received unqualified opinions on their FY 1998 financial statements. Just three missed this milestone with their FY 2010 financial statements. So for most agencies, their first opinions weren't unqualified – many received disclaimer opinions for several years. Yet a disclaimer can be the clearest roadmap for an organization seeking an unqualified opinion. It gives leadership the clear direction they need on where to focus audit remediation efforts.

So, auditing an entity for the first time is the first step in an organization's audit maturity process. With a first audit, management is making transparent to the auditors the organization's financial statements, internal controls, and the information used to manage the financial and performance aspects of the enterprise. Auditors simply test the information to ensure it is (1) fairly and accurately presented (i.e., free of material errors), (2) presented in accordance with standards and management policies, and (3) in compliance with accounting standards. It is important to remember what an audit opinion is and what it is not. An unqualified opinion means the financial information, as presented in the statements, are not materially misstated. Even with an unqualified opinion, more often than not, federal departments and agencies still suffer from lack of compliance with laws and regulations or weaknesses in internal controls.

DOD is among the most complex organizations in the world. I cannot improve upon the way GAO put it:

DOD is one of the largest and most complex organizations in the world. For fiscal year 2012, the budget requested for the department was approximately \$671 billion—\$553 billion in discretionary budget authority and \$118 billion to support overseas contingency operations. The fiscal year 2012 budget request also noted that DOD employed over 3 million military and civilian personnel—including active and reserve service members. DOD operations span a wide range of defense organizations, including the military departments and their respective major commands and functional activities, large defense agencies and field activities, and various combatant and joint operational commands that are responsible for military operations for specific geographic regions or theaters of operation. To execute its operations, the department performs interrelated and interdependent business functions, including financial management, logistics management, health care management, and

procurement. To support its business functions, DOD has reported that it relies on over 2,200 business systems, including accounting, acquisition, logistics, and personnel systems.²

Like almost every action it takes, DOD's audit will be the single largest audit undertaken . . . ever. The complexity is compounded by the fact that DOD's operations span our nation's history, while the focus on audit readiness is relatively recent. Most large companies undergoing an audit for the first time are "audit ready" from day one. The drive for profit ingrains in private sector personnel the essential nature of financial managers to decision making. Companies recognize that without the financial managers' input into key business decisions, they don't have an adequate understanding of the availability of resources to carry out operations. That "nature" has not been part of the federal government's way to doing business. In the past, execution of mission, despite costs and resources needed, was paramount and the practice was that the needed funding just appeared. There was no constraint. While that is changing today within the Department and the federal government as a whole, past practices are slow to change because of the size and nature of the entities involved. Financial statements still reflect transactions based on the business processes of the past. So expecting a clean audit the first time auditors go into an organization is unrealistic, particularly in the case of an organization the size, complexity and history of the Department of Defense.

Just as we should manage our expectations of DOD's audit readiness, we should also ensure we are imposing realistic deadlines. In a publicly traded company, auditors are in an organization every quarter, but still have 90 days to audit financial statements. Though the CFO Act originally set the deadline for audited financial statements at March 31st, today OMB has accelerated that date to no later than 45 calendar days after the end of the fiscal year. In my view, it is simply impractical to subject an organization as complex as DOD to this unreasonable deadline when its first subjected to audit scrutiny, especially when publicly traded counterparts of much smaller size and less complexity have twice as long to accomplish the same task.

Clear lines of responsibilities among DOD agencies and service providers are lacking

DOD agencies rely on a complex web of service providers (e.g., DFAS and DISA) to support them in the performance of their mission. As such, DOD agencies rely on these service providers to perform financial management functions (e.g., internal controls, transaction processing, and system maintenance). In carrying out these functions, DOD agencies often assume proper internal controls exist within the service providers, while service providers rightly assume that such policies and procedures are the responsibility of agency management. It may surprise panel members to know that DOD service provider policies, procedures, and controls aren't subjected to the same scrutiny as service providers in other agencies. SSAE No. 16 -- Statement on Standards for Attestation Engagements No. 16, Reporting on Controls at a Service Organization -- is the standard set by the American Institute of Certified Public Accountants for judging the adequacy of controls in place in service

² Id.

organizations. It is required at civilian public sector service providers like the Bureau of Public Debt and the Department of the Interior's data center. DOD agencies need confidence that service providers have proper internal controls. This confidence can only be gained through what are called SSAE 16 audits. DOD agencies and service providers also need a service provider agreement that documents what the service provider is to do for the agencies. That agreement should include detailed descriptions of internal controls. Today, this disconnect results in poor controls and injects risk in every transaction.

This should not absolve DOD agencies of their own responsibility. DOD agencies should not rely on outside entities for their financial management. Agency management must be accountable for financial management – financial management policies, procedures, and the resulting data – and make its reliability a priority. Delegating this responsibility to service providers or others will dilute accountability and the accuracy and reliability of financial information will suffer.

Weak internal control environment

Internal controls are the plans, methods, and procedures that provide reasonable assurance that objectives are being achieved in the following areas: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations. Financial statement audits often find weaknesses in these areas and make recommendations on how to improve. In an organization as large, complex, and decentralized as DOD, a uniform approach to internal controls would greatly enhance financial management throughout the enterprise. Otherwise, Defense agencies and service providers are left to adopt their own approach to internal controls, which leaves sound financial management to chance. Moreover, without a uniform approach, it is difficult to share and adopt lessons learned in all DOD agencies and service providers. The DOD controls environment is far from standard, resulting in a decentralized, sometimes ineffective, financial management environment. While a weakened internal control environment, in itself, does not mean an opinion cannot be issued on the Department's financial statements, it does mean that the audit is more time consuming and costly.

Legacy data and systems

As described in the previously cited GAO report, DOD financial management “relies on over 2,200 business systems.” This would be difficult enough were such systems under some standardization. Unfortunately, consistent policies on data management are not in place. For instance, financial data in some systems, though important for budget execution, is not required to be maintained for any period of time. Likewise, beginning balances are often unauditible. There is simply no consistent policy for maintaining data and records that meet professional standards.

In my view, DOD should not go back and undo the sins of the past – the cost of auditing old transactions recorded in financial systems would far outweigh the benefits. But it does need standard policies and procedures in place to govern systems and the data they maintain. DOD must be able to provide auditors data that support reported balances in a timely fashion. Furthermore, all shared systems and processes

should undergo SSAE 16 testing to enhance their efficiency and cut the cost of the audit.

DoD's financial management workforce

Human capital is a major management challenge throughout the federal government. But the chain of command in the Defense community, like in other areas, adds complexity. Financial management officials at headquarters have no authority over financial management professionals in the field. Under such circumstances, local financial managers are more loyal to local commanders than to top DOD and component financial executives. This lack of a financial management chain of command makes it difficult to apply consistent financial management policies and standardized processes throughout the Defense enterprise.

Too many layers of management in DOD financial management organizations also impede progress. Flattening organization structures throughout DOD's financial management workforce would improve audit timeliness and efficiency.

Conclusion

I've discussed the challenges to audit readiness, as requested. And though they are many, the talent and energy being invested by DOD in improved financial management is unprecedented. With DoD's continued leadership and attention, and the support and pressure applied by panels such as this one, I am sure we will soon be reminiscing about just how steep this climb seemed at one time. World class financial management at DOD could be here before we know it.

About Tracy Porter, CPA, CGFM

Ms. Porter is a Partner at Grant Thornton with more than 22 years of experience in the audit and evaluation of federal government financial statements, internal controls, and accounting and financial management systems and operations. She has overseen many projects on federal accounting, financial management, auditing and budget, along with developing and revising operating policies and procedures for federal agencies and designing or evaluating financial reporting internal controls. In addition, she has directed projects aimed at helping agencies obtain unqualified audit opinions. Ms. Porter has extensive experience and expertise in Department of Defense financial management, including in reporting, accounting, budgeting, and disbursing.

About Grant Thornton LLP

The people in the independent firms of Grant Thornton International Ltd provide personalized attention and the highest-quality service to public and private clients in more than 100 countries. Grant Thornton LLP is the U.S. member firm of Grant Thornton International Ltd, one of the six global audit, tax and advisory organizations. Grant Thornton International Ltd and its member firms are not a worldwide partnership, as each member firm is a separate and distinct legal entity. Grant Thornton's Global Public Sector, based in Alexandria, Va., provides expert audit and audit readiness services to major federal departments and agencies and to state and local governments.

Visit Global Public Sector at www.grantthornton.com/publicsector.

**Tracy Porter**

Partner – Global Public Sector
Grant Thornton LLP

Tracy has over 21 years of experience in the audit and evaluation of federal government financial statements, internal controls, and accounting and financial management systems and operations. She has overseen numerous large engagements demonstrating her extensive knowledge of federal accounting, financial management, auditing and budgeting to include developing and revising operating policies and procedures for federal agencies and designing or evaluating financial reporting internal controls. She specializes in auditing federal government financial statements as well as preparing federal government agencies for audit. Tracy has extensive experience and special expertise in Department of Defense financial management.

Before joining Grant Thornton, she was a Senior Auditor with the Government Accountability Office where she was responsible for auditing the financial statement and internal controls of Department of Defense entities.

Tracy is a graduate of West Liberty State College in West Liberty, WV. She is a licensed Certified Public Accountant (VA and DC) and a Certified Government Financial Manager. She is member of the American Institute of Certified Public Accountants and the Virginia Society of Certified Public Accountants and active in the Northern Virginia Chapter of the Association of Government Accountants and the Washington DC Chapter of the American Society of Military Comptrollers.

Tracy resides in Centreville, VA with her two children.

**DISCLOSURE FORM FOR WITNESSES
CONCERNING FEDERAL CONTRACT AND GRANT INFORMATION**

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Witness name: TRACY PORTER

Capacity in which appearing: (check one)

Individual

Representative

If appearing in a representative capacity, name of the company, association or other entity being represented: GRANT THORNTON LLP

FISCAL YEAR 2011

federal grant(s)/ contracts	federal agency	dollar value	subject(s) of contract or grant
- SEE ATTACHED -			

FISCAL YEAR 2010

federal grant(s)/ contracts	federal agency	dollar value	subject(s) of contract or grant
- SEE ATTACHED -			

FISCAL YEAR 2009

Federal grant(s)/ contracts	federal agency	dollar value	subject(s) of contract or grant
- SEE ATTACHED -			

Federal Contract Information: If you or the entity you represent before the Committee on Armed Services has contracts (including subcontracts) with the federal government, please provide the following information:

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Current fiscal year (2011): _____;
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Fiscal year 2009: _____

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Current fiscal year (2011): _____ ;
Fiscal year 2010: _____ ;
Fiscal year 2009: _____



November 14, 2011

The Honorable K. Michael Conaway
Chairman
Panel on Defense Financial Management and Auditability Reform
Committee on Armed Services
Washington, DC 20515-6035

Audit • Tax • Advisory
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F 703.837.4455
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Dear Chairman Conaway:

In response to the requirement in Rule 11, clause 2(g)(5), of the Rules of the U.S. House of Representatives for the 112th Congress to disclose the amount and source of federal contracts and grants by my employer, Grant Thornton LLP, I offer the following:

Grant Thornton LLP does a substantial amount of business with the federal government. It has contracts with most major federal agencies. It performs audit and audit readiness work under contracts with federal agencies, as well. Grant Thornton's DUNS Number is 128159105 and its CAGE Code is 1CDS1.

Please let me know if you require further detail to satisfy this requirement.

Sincerely,

A handwritten signature in cursive script that reads "Tracy Porter".

Tracy Porter
Partner
Grant Thornton
Global Public Sector
333 John Carlyle Street, Suite 500
Alexandria, VA 22314-5745

Department of Defense Audit Impediments and Audit Readiness Testimony**Mr. Mark Keeley****Partner, PricewaterhouseCoopers LLP****November 17, 2011**

Chairman Conaway, Ranking Member Andrews, and Members of the Panel, it is a pleasure to be here today to share my perspectives about "the impediments to the Department of Defense (DoD) achieving audit readiness and the actions DoD needs to take to become audit ready." My audit readiness perspectives come from 27 years of public accounting experience, including 20 years in the commercial sector and seven years working with the DoD. My experience is primarily in information systems auditing, but I will also offer an informed opinion today, to the extent that I am able, on broad audit readiness matters within the DoD. The Firm in which I am a partner, PricewaterhouseCoopers LLP (PwC), has performed first time audits of several Federal government departments and DoD entities, including the financial statement audits of the United States Army Corps of Engineers - Civil Works (USACE) and an intelligence community agency. We have also performed the service organization audit of the Defense Information Systems Agency (DISA). In addition, PwC has worked with the DoD in an advisory capacity since the passage of the Chief Financial Officers' Act of 1990 (the CFO Act) by assisting with implementation of the Act at DoD. Among other engagements, PwC has been providing audit readiness advice to the Office of the Under Secretary of Defense (Comptroller) ((OUSDC)), Financial Improvement and Audit Readiness (FIAR) Directorate for the past three years. My own perspectives have been formed by my work on five successful projects that are relevant to today's topic:

- 1) The first service organization audit of DISA,
- 2) The first financial statement audit of the USACE, where I was responsible for the information systems aspects of the audit,
- 3) The development and implementation of the FIAR Guidance, which provides step-by-step audit readiness instructions for each DoD Component,
- 4) The development and delivery of the FIAR Directorate's three-day audit readiness professional development course, including a half day leadership-level course, to over 1,000 DoD professionals, and
- 5) The signing of the unqualified examination opinion on the audit readiness of the Air Force Fund Balance with Treasury Reconciliation Process.

These five projects provide a basis for the audit readiness insights I will share today.

As I was preparing to testify, I happened to visit the Department of Energy. The lobby of the Department's headquarters contains a prominent display about the Manhattan Project and the role of Albert Einstein. The display reminded me of a quotation by Albert Einstein that is relevant to today's topic, "We cannot solve problems by using the same kind of thinking we used when we created them." The DoD did not intend to create the audit readiness challenges it has today. Rather, the DoD developed and implemented processes and systems tailored to achieve its overall functional mission, and audit readiness then became an imperative. Because the DoD's incumbent processes and systems were not originally designed to meet audit readiness, a "new kind of thinking" will be required for the DoD to address the requirements of an audit-ready organization.

Since the CFO Act was passed in 1990, one of the most significant changes in audit readiness thinking that has occurred in the DoD is the development and implementation of a financial improvement and audit readiness strategy. Rather than attempt to audit an entire Component all

at once, the strategy prioritizes financial improvement work into manageable waves of audit activity. The audit readiness of the statement of budgetary resources (SBR) by 2014 is a high priority wave of audit activity and a primary reason for our presence here today. The DoD has already made significant audit readiness progress. For example, the May 2011 FIAR Plan Status Report states that DoD organizations with unqualified audit opinions received \$96 billion dollars in budgetary resources in fiscal year 2010, which is already more than the budgetary resources under audit in 13 of the 24 agencies subject to the CFO Act.

Although progress has been made towards audit readiness, the pace of progress must accelerate if the DoD is to meet the 2014 SBR audit readiness date and the 2017 overall audit readiness date. The work ethic of DoD personnel is strong and the DoD can accomplish any goal it sets for itself. The 60-day SBR plans that are currently being developed by each Component will soon provide detailed blueprints for how the DoD will meet the latest audit readiness deadlines. Based on PwC's experience to date, the DoD should continue to improve its financial management and audit readiness efforts in three ways, as the 60-day plans are implemented:

- 1) **Enhance the skills of personnel resources through the addition of certified public accountants (CPAs) with financial statement audit experience and continue to implement of the OUSD(C)'s financial improvement and audit readiness professional development program and the financial management certification program.**

Although the DoD has to date spent a great deal of time and energy documenting processes, we have learned that the greatest benefit to audit readiness is typically a consequence of testing controls and testing for the existence of supporting documentation and then quickly remediating the problems identified through the testing. This type of test work requires appropriately trained and skilled auditors.

As stated in the FIAR Guidance, the management of human capital is a significant element of the internal controls environment. Although hiring CPAs is an important aspect of improving the human capital necessary to achieve audit readiness, not all CPAs have the requisite audit readiness expertise. CPAs who specialize in areas such as tax, budgets, or systems may not have developed the tools necessary to productively participate in improving audit readiness. For example, the Government Accountability Office (GAO) Financial Audit Manual and the Yellow Book of Government Auditing Standards use the word "judgment" more than 270 times throughout 1,300 pages. CPAs who have federal financial statement audit experience are trained to apply this judgment such that they can make the decisions on controls and documentation necessary to successfully prepare the DoD for a financial statement audit.

The OUSD(C) is in the process of evaluating its resources and implementing a financial management certification program, the key goals of which include a framework for financial management development and a mechanism for financial management training, decision support, and career leadership. The work ethic of DoD personnel is strong, but the additional skills they can gain through this certification program will make them more productive.

- 2) **Ensure that functional leaders and financial leaders throughout the DoD, including the leaders of Components as well as shared service organizations, are held equally accountable for audit readiness.**

As stated in the FIAR Guidance, senior leadership oversight for audit readiness is driven by the Deputy Secretary of Defense/Chief Management Officer, the Under Secretary of Defense (Comptroller), the DoD Deputy Chief Management Officers, the Military Department Chief Management Officers and Financial Management/Comptrollers, as well as

senior leaders from the functional and financial communities. The majority of internal controls and documentation that must be analyzed in a financial statement audit are owned by functional areas rather than financial areas. For example, records of promotions used to pay service members are maintained by the Personnel & Readiness community. The functional areas must maintain data in an auditable form to accomplish a financial statement audit. However, functional personnel and financial personnel do not need the same type of training. Of course, functional personnel need to be trained to achieve their functional mission, such as maintaining property, but they should also be trained to understand financial objectives, such as the completeness of property records. Similarly, financial personnel should be trained to understand the activities of functional areas, but the financial people should have a primary role in working with functional personnel to design effective internal controls and quality documentation standards that functional people can follow, such as the proper storage of property documents in an easily accessible manner. In addition to the nature and extent of training provided to functional and financial personnel, the degree of standardization used to design and implement effective internal controls impacts audit readiness. Standardization improves the efficiency of an audit and generally improves the efficiency of an organization, but can be particularly complex to accomplish from a business perspective. For example, DoD's acquisition process is significantly complex and relies upon multiple systems and various skilled resources, but it is a worthwhile goal that is garnering attention from DoD leadership, especially with respect to ERP implementations. As functional and financial personnel are trained in their respective financial responsibilities and the degree of standardization is determined, functional and financial leaders throughout the DoD should be held equally accountable for audit readiness. This is already happening through organizational and individual performance plans and evaluations, but must continue to be emphasized.

The DoD has more service providers (agencies performing processes, managing systems and hosting systems that affect Component financial statements) than any other Federal department. The DoD recognizes that shared service organizations must be audit ready in order for their customer Components to be audit ready. The DoD is making a concerted effort to align the roles and responsibilities of shared services organizations, such as the Defense Finance and Accounting Service (DFAS) and DISA, with the audit readiness needs of the Components. These efforts are now taking place and are happening at a detailed level, such as the mapping of each service provider's transaction processing activities to financial statement control objectives that the Components and their auditors need to see.

3) Ensure legacy or ERP systems are configured to report data in the financial statements as prescribed by Generally Accepted Accounting Principles (GAAP), and also ensure that computer controls are designed into ERP systems throughout the entire implementation process.

Auditors are system agnostic - that is, a system does not need to be an ERP solution to be auditable. Rather, to achieve audit readiness, systems must do three main things:

- 1) Process transactions in accordance with GAAP,
- 2) Capture and retain transaction data so that it can be traced to the financial statements (e.g. produce an audit trail), and
- 3) Maintain transaction data in a reliable computer control environment.

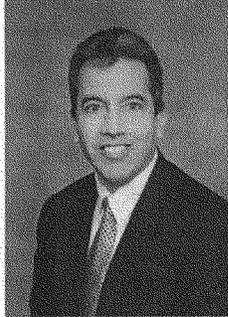
ERPs can facilitate the achievement of these requirements, but they are not solutions by themselves. Systems will only do what we tell them to do. For example, if a legacy system was not properly designed to process an accounting transaction, changes to the underlying

accounting treatment would need to be understood before new system logic is developed or the legacy system is upgraded to an ERP solution. The DoD should continue to follow the FIAR Directorate's requirement that Components begin by demonstrating how the implementation of ERPs (or the modernization of older legacy systems) will address known internal control deficiencies and process compliance issues.

I am a systems auditor rather than a systems implementer, and therefore have not been involved in determining whether an old system is updated or replaced entirely with an ERP solution. However, I have been involved in auditing ERPs. The DoD's ERPs use well-known, proven technology that is inherently controllable. However, computer controls that may not have existed in the older systems need to be considered up front and programmed into any new or upgraded system. The "E" in ERP means "Enterprise," but an ERP solution rarely replaces an entire systems environment. ERP's inevitably need to speak to older systems. Accounting and auditing expertise is necessary to figure out which controls need to stay in the old systems, which controls need to be programmed into the new system, and which controls need to be programmed into the interface between the two systems.

Systems implementation projects are understandably focused on system functionality, while some key controls, especially those related to logical security, are sometimes implemented as a secondary activity. Implementing system functionality and controls at the same time increases ERP project complexity, but leads to improved audit readiness. If enough key controls are not implemented into the ERP in time for a financial statement audit, an auditor may not be able to rely on the data. For example, on one of my first year audits the payroll data came from a system that did not provide sufficient internal controls, so we were required to statistically test 800 sample items across the United States, which required 8,000 hours. In the second year of the audit, the payroll system provided some reliance on internal controls, so we were able to perform much less test work, reducing our time to approximately 400 hours. In order to apply lessons learned from this first-year audit experience, all ERP projects should involve audit readiness professionals who have Federal financial systems audit experience, so that they can ensure that the systems subject to a financial statement audit satisfy the computer control objectives established in the Federal Information Systems Control Audit Manual (FISCAM). The FIAR Directorate has already made significant progress helping the Components understand the applicability of FISCAM to their computer processing environments.

I would be pleased to expand further on these three areas during the question and answer period today.



Mark Keeley is a Partner with PricewaterhouseCoopers LLP (PwC). He is responsible for his Firm's Financial Management and Information Systems Audit Practice dedicated to the Department of Defense (DoD). Mr. Keeley is a Certified Public Accountant (CPA) and a Certified Information Technology Professional (CITP). He holds a Bachelor of Science in Accounting and Computer Science from the University of Massachusetts at Amherst and a Master of Science in Finance from Boston College. His audit readiness perspectives come from 27 years of public accounting experience, including 20 years in the commercial sector and 7 years working with the DoD. His perspectives that are most relevant to financial improvement and audit readiness in the DoD have been formed by his involvement in five areas of success within the Department:

- 1) The first service organization audit of the Defense Information Systems Agency (DISA),
- 2) The first financial statement audit of the US Army Corps of Engineers - Civil Works, where he was responsible for the information systems aspects of the audit,
- 3) The development and implementation of the Office of the Under Secretary of Defense (Comptroller)'s (OUSD(C))'s Financial Improvement and Audit Readiness (FIAR) Guidance, which provides step by step audit readiness instructions that each Department Component can follow to achieve audit readiness,
- 4) The development and instruction of the OUSD(C)'s three day audit readiness professional development course to over 1,500 DoD professionals, and
- 5) The signing of the unqualified examination opinion of the Air Force Fund Balance with Treasury Reconciliation Process.

**DISCLOSURE FORM FOR WITNESSES
CONCERNING FEDERAL CONTRACT AND GRANT INFORMATION**

INSTRUCTION TO WITNESSES: Rule 11, clause 2(g)(5), of the Rules of the U.S. House of Representatives for the 112th Congress requires nongovernmental witnesses appearing before House committees to include in their written statements a curriculum vitae and a disclosure of the amount and source of any federal contracts or grants (including subcontracts and subgrants) received during the current and two previous fiscal years either by the witness or by an entity represented by the witness. This form is intended to assist witnesses appearing before the House Armed Services Committee in complying with the House rule.

Witness name: Mark J. Keeley

Capacity in which appearing: (check one)

Individual

Representative

If appearing in a representative capacity, name of the company, association or other entity being represented: PricewaterhouseCoopers LLP

FISCAL YEAR 2011

federal grant(s)/ contracts	federal agency	dollar value	subject(s) of contract or grant
See Attached			

FISCAL YEAR 2010

federal grant(s)/ contracts	federal agency	dollar value	subject(s) of contract or grant

FISCAL YEAR 2009

Federal grant(s)/ contracts	federal agency	dollar value	subject(s) of contract or grant

Federal Contract Information: If you or the entity you represent before the Committee on Armed Services has contracts (including subcontracts) with the federal government, please provide the following information:

Number of contracts (including subcontracts) with the federal government:

Current fiscal year (2011): _____;
 Fiscal year 2010: _____;
 Fiscal year 2009: _____.

Federal agencies with which federal contracts are held:

Current fiscal year (2011): _____;
 Fiscal year 2010: _____;
 Fiscal year 2009: _____.

List of subjects of federal contract(s) (for example, ship construction, aircraft parts manufacturing, software design, force structure consultant, architecture & engineering services, etc.):

Current fiscal year (2011): _____;
 Fiscal year 2010: _____;
 Fiscal year 2009: _____.

Aggregate dollar value of federal contracts held:

Current fiscal year (2011): _____;
 Fiscal year 2010: _____;
 Fiscal year 2009: _____.

Federal Grant Information: If you or the entity you represent before the Committee on Armed Services has grants (including subgrants) with the federal government, please provide the following information:

Number of grants (including subgrants) with the federal government:

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.

Federal agencies with which federal grants are held:

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.

List of subjects of federal grants(s) (for example, materials research, sociological study, software design, etc.):

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.

Aggregate dollar value of federal grants held:

Current fiscal year (2011): _____;
Fiscal year 2010: _____;
Fiscal year 2009: _____.



ADDENDUM TO DISCLOSURE FORM FOR WITNESSES CONCERNING FEDERAL CONTRACT AND GRANT INFORMATION

PricewaterhouseCoopers LLP (PwC) is pleased to submit to the U.S. House of Representatives House Armed Services Committee our response to Rule 11, clause 2(g)(5), of the Rules of the U.S. House of Representatives for the 112th Congress. PwC has no grant information to disclose that is germane to PwC's November 17, 2011 financial improvement and audit readiness testimony. The amount of Department of Defense contract (including subcontract) awards received during the current and two previous fiscal years (2009, 2010 and 2011) by PwC for work that is germane to PwC's November 17, 2011 financial improvement and audit readiness testimony is as follows:

Nine (9) contracts whereby PwC is the prime contractor in the amount of \$30,471,645.

Five (5) contracts whereby PwC is a subcontractor in the amount of \$1,492,847.

PwC appreciates the opportunity provide our perspectives on the impediments to DoD achieving audit readiness and the actions DoD needs to take to become audit ready.

DOCUMENTS SUBMITTED FOR THE RECORD

NOVEMBER 17, 2011

***DoD Audit Readiness
Essentials***

An Insider's Answers to
Your Most Commonly
Asked Questions

www.pwc.com/publicsector



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Introduction >

The enactment of the Chief Financial Officers' Act (CFO Act) of 1990 and the Government Management Reform Act (GMRA) of 1994 opened a new era of financial management in the Federal government. These two laws meant that Federal Executive Agencies were required by law to prepare financial statements and have them audited by independent auditors.

PricewaterhouseCoopers LLP has provided extensive internal control assessments and CFO Audit Act implementation support for two decades.

We have served a number of Federal Executive Agencies by helping them succeed with audit readiness efforts and achieve a sustainable audit opinion.

This guide, "DoD Audit Readiness Essentials," outlines key audit readiness competencies that have proven successful with Executive Civilian Agencies and Department of Defense (DoD) Organizations that have achieved clean audit opinions. We have prepared it to help the Department as a whole take the right steps to achieve and sustain a clean audit opinion.

We have identified the five essential audit readiness competencies - presented as pillars in Figure 1 - and structured this guide to discuss each one so they may be adequately addressed in preparation for a full-scope financial statement audit:

- **Leadership Support:** Leadership support is defined by a culture in which operational leaders champion audit readiness. Leadership support from across the Component creates a synergistic environment that helps to influence coordination and cooperation in achieving audit readiness.
- **Audit Readiness Human Capital:** Appropriate audit readiness human capital means having the right people with the right skills, education, and experience to identify audit readiness impediments and develop workable solutions. Audit readiness human capital will help address the necessary internal controls or sets of controls (automated and manual), as well as determine the adequacy of supporting

Fast Facts

The CFO Act complemented the management control objectives required by the Federal Managers Financial Integrity Act of 1982 (FMFIA) to improve effectiveness and accountability through the cycles of planning, budgeting, managing, accounting, and auditing. The CFO Act additionally mandated financial management reforms, stressing the Federal government's responsibility in fiscal matters.

The success of the CFO Act and FMFIA helped form the basis of the Government Management Reform Act (GMRA) that expanded to all 24 CFO Act agencies the requirement for the preparation and audit of financial statements. For the first time, GMRA tasked Treasury to prepare consolidated financial statements for executive branch operations.

documentation and the reliance on proper information systems and data.

- **Internal Controls:** Internal controls is the set of procedures designed, implemented, and maintained to provide reasonable assurance about the achievement of reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Effective internal controls demonstrate a Component's ability to assert that its financial statements are fairly stated in accordance with generally accepted accounting principles.
- **Supporting Documentation:** A Component's supporting documentation is comprised of electronic and hard-copy evidence supporting the amount, classification, summarization, and reporting of individual business events. Organizations must produce adequate supporting documentation to allow auditors to conclude on the

fair presentation of the financial statements.

- **Information Technology:** Information technology includes the Enterprise Resource Planning (ERP) financial systems, feeder systems, micro-applications, and electronic data necessary to prepare the Component's financial statements. The ability to rely on electronic data is contingent upon effective information technology controls within and between systems.

Within each of these audit readiness competencies, we will answer the questions most commonly asked by organizations working to become audit-ready. The answers presented in this guide are based on audit standards combined with our cumulative experience performing Federal financial statement audits and audit readiness projects. In addition to providing answers, we also discuss practical solutions as to how Organizations can get started with audit readiness.

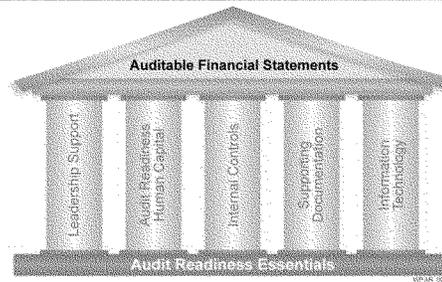


Figure 1: The five essential audit readiness competencies.

Leadership Support

Commonly asked questions:

- Why do I need leadership support for audit readiness success?
- How do I communicate the value of a financial statement audit?
- How does audit readiness benefit my organization?
- How do I get started obtaining organizational support for audit readiness activities?

Introduction

We have noted one common attribute resident within Federal organizations that have been successful with audit readiness and have received unqualified audit opinions. This is support from leaders across the organization. Organizational leadership support jump-starts an Organization's ability to achieve auditable financial statements and accelerates its progress toward audit readiness.

Audit standards help define exactly who in the organization needs to be involved in a financial statement audit and, therefore, in audit readiness efforts. Organizational leadership consists of more than the Chief Financial Officer (CFO) and supportive financial managers. Organizational leadership must include those individuals who have responsibility for the strategic direction of the organization. In other words, leadership is required from the Commanding General and equivalent leaders of programs and missions. The audit community in both the commercial and Federal space has found that to be successful, organization heads must be supportive of and actively engaged in audit readiness efforts.

Why do I need leadership support for audit readiness success?

Often, organizations undergoing audit readiness initiatives believe that audit readiness responsibilities lie solely with the Chief Financial Officer (CFO). This typically leads

to delays in audit readiness progress or even audit failure, because CFO's may not have the necessary authority to effect change for business processes outside of their domain. For example, auditors require transaction source documents, such as invoices and receiving reports for purchased items, in order to perform financial tests. However, the CFO does not physically control the use and retention of such documentation. The inability to engage organizational leadership to support audit readiness efforts often leads to work-around solutions executed within the finance office. These are often inefficient and ineffective, thereby increasing the cost to the organization rather than realizing the true value of audit readiness, which is to provide reliable data that increases the efficiency and effectiveness of mission operations.

Consequently, the CFO needs support from the organization's leadership to drive change and monitor progress within the organization's program/mission areas.

In April 2006, the DoD Office of the Inspector General (OIG) contracted PwC to support its Fiscal Year (FY) 2006, FY 2007, and FY 2008 audits of the USACE/Civil Works financial statements. This was the first Independent Public Accountant (IPA)-assisted financial statement audit of USACE in its 230-plus year history. This was the first major entity approved for audit under the DoD Financial Improvement Audit Readiness (FIAR) program.

One of the catalysts for the audit's success was the Commander's support. The Commanding General required division

and district Commanders to thoroughly support audit efforts. The USACE Commander required the business unit commands to report the status and/or success of their audit efforts on a monthly basis. Additionally, the USACE Chief of Staff actively participated in all internal progress reviews (audit status meetings) to implement solutions to overcome audit impediments across all commands.

Organizations should emulate the USACE approach to create leadership support across program/mission areas. To ensure success, the Commanding General needs to require the leaders of each program/mission area to be accountable for audit readiness efforts. Additionally, the Chief of Staff should participate in all audit readiness status meetings to monitor, support and facilitate the resolution of cross-organizational impediments or issues.

How do I communicate the value of a financial statement audit?

Many organizational leaders within the DoD have never experienced a financial statement audit. Therefore, it is important that financial managers be able to help them understand the merits and appreciate the value of a financial statement audit. Independent auditor reports provide stakeholders (Congress, oversight bodies, taxpayers, etc.) with an independent third-party opinion as to whether the organization's financial results are fairly stated in accordance with Generally Accepted Accounting Principles (GAAP). Stakeholders can use this information to conclude whether the organization can demonstrate accountability for its Federal funding and execute its mission(s) in an effective and

Leadership Support

Statement of Auditing Standards (SAS) No. 114, *The Auditor's Communication with Those Charged with Governance*, requires auditors to communicate with organizational leadership and defines the leaders as "those who have responsibility for the strategic direction of the organization."

efficient manner. Furthermore, Federal organizations that can demonstrate fiscal responsibility through independent financial statement audits will have increased credibility with stakeholders, Congressional committees, and the American people.

The true value of a financial statement audit lies not just in compliance, which is mandatory, but in the improved processes and controls that undergird mission operations and make for a more effective and powerful fighting force.

How does audit readiness benefit my organization?

Organizations manage their operations based upon budgetary resources and expenditures. Sound budgetary data helps leaders gauge the use of funds toward mission achievement. Audit readiness improves the quality of financial information, which improves the efficiency and effectiveness of mission programs. Mission funds are used to execute business events which are linked to accounting transactions for financial reporting, leading to better data for decision-making.

Audit readiness links business event activities to accounting transactions and ensures that the accounting transactions

are properly reported in the financial records. The ability to link business events processed through an end-to-end business process to accounting transactions is critical to successful audit readiness. For example, a military payroll transaction is initiated when service men/women produce goods or services—a business event. The accounting transaction is evidenced by leave slips used to record costs, benefit expense and benefit liabilities. Correct leave slips are the link between the business event and the accounting transaction. Audit readiness ensures that the processes to record military pay have the proper internal controls to effectively and efficiently expedite payroll processing, while maintaining adequate documentation as evidence to support the financial reporting of the business event -- thereby executing the mission.

Recording business events in financial records also provides program/mission leaders a repository of data with which to manage their programs. This eliminates the need to have separate spreadsheets and/or reports created outside of the financial records for decision-making purposes, enabling program/mission leaders to do more with less.

How do I get started obtaining organizational support for audit readiness activities?



Figure 2: Organizational leadership support is necessary for successful audit readiness.

Organizations may follow the steps below to obtain support from leaders for audit readiness initiatives.

Step 1: Demonstrate why leadership support is necessary. Be prepared to demonstrate why organization leadership support, shown in Figure 2, is necessary. The CFO or the audit readiness financial manager may have to get involved with the organization's program/mission areas to educate leaders on the need for audit readiness – a time-consuming process. One organization that recently achieved a clean audit opinion spent nearly 18 months on consistent communication and education by the CFO and Director of Audit Readiness. After 18 months, however, the program/mission leaders were voluntarily supportive of the audit readiness efforts, and even used improved

cost information to help them manage their programs/missions.

Step 2: Demonstrate the value of a financial statement audit. Most organizational leaders within the DoD come from a program/mission background and may not have experience with a financial statement audits. Therefore, it is important to be able to demonstrate that the value of a financial statement audit extends to the positive message it sends stakeholders. An unqualified audit opinion communicates that the financial management data of the organization is fairly stated – or, in other words, reliable.

Step 3: Demonstrate how audit readiness benefits the organization. Be prepared to discuss the value of audit readiness and have

a sound audit readiness plan that demonstrates a prioritized approach that includes interim milestones. The FIAR Guidance, which is issued by the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) FIAR Directorate, provides an authorized DoD audit readiness plan and methodology. It also prescribes the use of Financial Improvement Plans to monitor progress. It is important that organizational leaders be able to track audit readiness progress via measurable milestones to monitor how improvements translate into benefits to the organization.

Step 4: Develop a process to monitor support. Create a process for leadership to remain engaged in audit readiness to sustain momentum and drive organization-wide improvements. As noted earlier with the USACE example, the CFO was able to work with the Commanding General to establish a process for continual leadership monitoring and support throughout the audit readiness effort and, eventually, the audit. The Commander held each division/directorate responsible for audit status. Monthly progress reports were given to the General Commander. Additionally, the Chief of Staff attended all internal progress review meetings. This same approach should be used for audit readiness efforts, as well as to ensure consistent organization support and awareness. It may also be appropriate for the Commander to provide financial incentives to Senior Executives for audit readiness success in their annual development plans.

Execution of each of these steps will lead to the final objective of obtaining leadership support – which, in turn, will drive effective audit readiness progress leading to a successful and sustainable audit.

Audit Readiness Human Capital

Commonly asked questions:

- What types of personnel are necessary to achieve audit readiness and demonstrate financial improvement?
- Have I done enough to ensure my team has adequate training to achieve audit readiness?
- How do I get started?

Successful audit readiness efforts begin with putting the appropriate human capital in place -- the right people with the right skills, education, and experience to identify audit readiness impediments and develop workable solutions. These human capital resources will put internal controls or sets of controls (automated and manual) in place to achieve the organization's mission and financial reporting objectives. They will also verify that adequate supporting documentation exists so the proper level of reliance can be placed on information systems and data. Without the right human capital, resources may be spent on treating the symptoms of a lack of organizational readiness rather than dealing with the root causes -- such as inadequate experience, training, or skills.

As part of evaluating whether an organization has the appropriate human capital in place, leadership should ask the following questions:

What types of personnel are necessary to achieve audit readiness and demonstrate financial improvement?

Organizations such as the DoD have operations that span the globe and encompass both public and private resources. Managing these complex operations requires hundreds of operational, accounting, and budgetary systems, as well as thousands of personnel to input and approve transactions. Demonstrating financial improvement and audit readiness requires an Organization to build adequate human capital with the proper competencies. The workforce must be dedicated to financial improvement and audit readiness activities. This calls for a multi-disciplined team with relevant skills, practical work experience, and sufficient and up-to-date training as shown in Figure 3. The following skills are required:

Auditors: Understand Federal audit requirements. Perform(ed) Federal financial statement audits, including the impact of information technology on audit readiness activities.

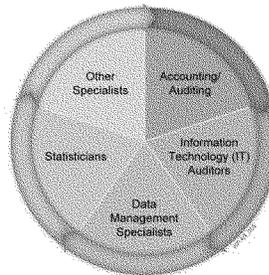


Figure 3: A multi-disciplinary team is critical to achieving financial improvement and audit readiness.

PwC's Leading Role in Audit Readiness

PwC has developed an entire curriculum of training courses designed to educate the DoD on the FIAR Guidance. Since developing the courses, only PwC has taught them to hundreds of DoD audit readiness professionals.

Information Technology Auditors: Understand information technology. Have a detailed, working knowledge of the Government Accountability Office's (GAO) Federal Information System Controls Audit Manual (FISCAM).

Data Management Specialists: Utilize data management tools such as ACL Services, IDEA, and Monarch to identify data anomalies, abnormalities, and irregularities. Demonstrate ability to segregate large volumes of data to facilitate sampling for audit readiness testing.

Statisticians: Understand statistical requirements and utilize tools such as SAS to facilitate sampling for audit readiness testing.

Other Specialists: Show proficiency with unique Federal programs such as Environmental Liabilities and their impact on audit readiness. For example, accounting requirements have specific criteria which detail when an environmental liability must be recognized and who must recognize it for financial reporting purposes, which may differ from when the actual event occurs.

Organizations working to become audit ready must have a combination of resources that includes representation from the competencies above to be successful. Without it, organizations run the risk of not reaching the appropriate conclusions at key decision points. Organizations that deploy a multi-disciplined team with accounting,

auditing, information technology, data management, and statistical skills will be able to best demonstrate financial improvement and audit readiness. *Figure 4* details the type of skills, experience, and certifications that audit readiness personnel should possess.

Have I done enough to ensure my team has adequate training to achieve audit readiness?

Once the appropriate audit readiness human capital resources are in place, audit readiness skills need to be sustained. This can be accomplished through continual training and the strategic assignment of resources to projects and tasks that challenge and grow each person's abilities.

Organizations such as the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), the Association of Government Accountants (AGA), and the American Society of Military Comptrollers (ASMC) provide audit readiness training. In addition, a number of private entities also provide accounting and auditing training for new, experienced, and seasoned personnel.

Category	Skills	Education/Coaching
<ul style="list-style-type: none"> Auditing Information Technology 	New Personnel <ul style="list-style-type: none"> Has zero to four years of experience Utilizes and demonstrates critical thinking skills Stays abreast of current Federal accounting, IT, and/or reporting standards Understands the DoD Organization's operations and systems Participates in discussions with personnel conducting operations to understand the impact on accounting Demonstrates professional skepticism Prepares quality documentation 	Auditing <ul style="list-style-type: none"> Bachelors in Accounting Information Technology <ul style="list-style-type: none"> Bachelors in Management Information Systems or similar major
	Seasoned Personnel <ul style="list-style-type: none"> Has four to 10 years of experience Understands DoD Organization operations and determines when to use a specialist Demonstrates thorough knowledge of Federal accounting, IT, and/or reporting standards and continuously develops technical knowledge Performs technical accounting research and forms conclusions Leads discussions with personnel conducting operations and determines the impact on audit readiness Leads and develops audit readiness personnel, provides guidance, and reviews audit readiness documentation Identifies and shares best practices and lessons learned Demonstrates professional skepticism 	Auditing <ul style="list-style-type: none"> Bachelors in Accounting Certified Public Accountant (CPA) Certified Government Financial Manager (CGFM) Certified Defense Financial Manager (CDFM) Information Technology <ul style="list-style-type: none"> Bachelors in Management Information Systems or similar major Certified Information Systems Auditor (CISA) Certified Information Security Manager (CISM) Certified in Governance of Enterprise IT (CGEIT) Certified Information Technology Professional (CITP)
	Experienced Personnel <ul style="list-style-type: none"> Has more than 10 years of experience Builds strong relationships with Senior Leadership to obtain buy-in and facilitate audit readiness activities Demonstrates a comprehensive understanding of Federal accounting, IT, and/or reporting standards as well as DoD's internal controls processes Demonstrates an understanding of audit requirements, including consideration of the IT environment Identifies and resolves impediments to audit readiness in a timely manner Drives collaboration and leads efforts to develop the audit readiness approach for assessable units Demonstrates the ability to deliver firm commands Ensures audit readiness personnel have sufficient and relevant training 	Auditing <ul style="list-style-type: none"> Bachelors in Accounting Certified Public Accountant (CPA) Certified Government Financial Manager (CGFM) Certified Defense Financial Manager (CDFM) Information Technology <ul style="list-style-type: none"> Bachelors in Management Information Systems or similar major Certified Information Systems Auditor (CISA) Certified Information Security Manager (CISM) Certified in Governance of Enterprise IT (CGEIT) Certified Information Technology Professional (CITP)
<ul style="list-style-type: none"> Data Management Statistics 	<ul style="list-style-type: none"> Uses data management tools to identify data abnormalities and anomalies Facilitates sampling for tests of controls and tests of supporting documentation Shows familiarity with Organization's data and system functionality Shows familiarity with the scope of a financial statement audit 	Data Management <ul style="list-style-type: none"> Bachelors in Management Information Systems or similar major Statistics <ul style="list-style-type: none"> Bachelors in Statistics, Mathematics, Economics, or similar major
<ul style="list-style-type: none"> Specialists 	<ul style="list-style-type: none"> Has a comprehensive understanding of the subject Has a comprehensive understanding of processes at the Organization Thoroughly understands the accounting and reporting standards 	<ul style="list-style-type: none"> Bachelors in Accounting Certified Public Accountant (CPA) Certified Government Financial Manager (CGFM) Certified Defense Financial Manager (CDFM) Certified Information System Security Professional (CISSP)

Figure 4: Organizations deploying multi-disciplinary teams will be best able to demonstrate financial improvement and audit readiness.

How do I get started?

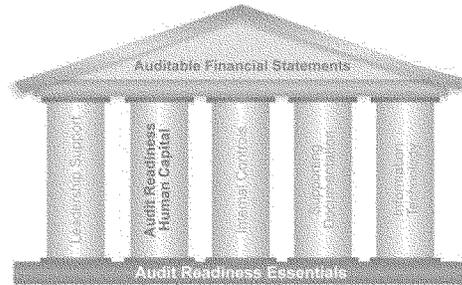


Figure 5: Organizations should define their human capital requirements for becoming audit ready.

Organizations may follow the steps presented below to ensure appropriate human capital is in place to support audit readiness efforts:

Step 1: Identify human capital requirements. Using the information above as a starting point, organizations should define their human capital requirements for becoming audit ready, as shown in Figure 5. This includes identifying the types and numbers of positions required to become audit ready, and then determining the skills, training, experience, and education

required for each type of position. These decisions should be documented in position descriptions that can be used for future hiring of personnel, as well as for soliciting contractor support.

Step 2: Assess current audit readiness human capital. Once the audit readiness positions have been defined, organizations should perform an assessment of their existing personnel and contractor resources. This assessment should survey personnel and compare their skills, training, experience, and education to those documented in the position descriptions.

Step 3: Improving existing audit readiness human capital. If gaps in skills, training, experience, or education are identified, the organization should develop a remediation plan. Ideally, current employees could be trained, attend additional education classes, or be offered rotations into other positions to allow them to close those gaps. In instances when that step is not practical, organizations should look for opportunities to rotate the personnel into another area where they may satisfy position requirements and create space for adding new resources.

Step 4: Adding audit readiness human capital. If organizations have open positions, they should use the position descriptions developed in Step 1 to find personnel (including contractors) who possess the appropriate skills, experience, training, and education to support audit readiness.

Internal Controls

Commonly asked questions:

- What are the benefits of considering internal controls within my audit readiness activities?
- What is a Control Activity and how do I distinguish between a Control Activity and a Business Process?
- What are Key Controls?
- How do I use a SSAE 16 Report on Controls at a Service Organization?
- How do I get started?

Introduction

Internal controls is the set of procedures designed, implemented, and maintained to provide reasonable assurance about the achievement of the organization's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Internal Controls Over Financial Reporting (ICOFR) are the procedures designed to provide reasonable assurance regarding the reliability of the organization's financial reporting. It starts at the initiation of a transaction and ends with the reporting of the related balances in the financial reports. Therefore, internal controls over the transaction process involve activities at each step of the end-to-end business process, including the initiation of the transaction,

maintenance of each transaction record, the recording of each transaction, and the ultimate financial reporting of the transactions. In addition, they include the prevention and detection of unauthorized acquisition and use or disposition of assets in relation to the transaction.

OMB Circular A-123, Appendix A provides guidance on compliance with the FMFIA and ICOFR. At its core, the circular requires the identification, documentation, assessment, testing, and reporting of the organization's internal controls over financial reporting. Therefore, the requirements of OMB Circular A-123 are a subset of DoD's audit readiness activities.

The FIAR Methodology, defined in the FIAR Guidance, includes tasks that can be leveraged to meet the ICOFR requirements contained within OMB Circular A-123, Appendix A. The organization's integrated execution of the FIAR Methodology satisfies the DoD's requirement for complying with ICOFR.

As noted in Office of Management and Budget (OMB) Circular A-123, management has a fundamental responsibility to develop and maintain effective internal controls. The proper stewardship of Federal resources is an essential responsibility of agency managers and staff.

What are the benefits of considering internal controls within my audit readiness activities?

When conducting an audit of a Federal entity, the financial statement auditor must follow auditing standards generally accepted in the U.S., Government Auditing Standards issued by the Comptroller General of the U.S., as well as OMB Audit Guidance. In addition to providing an opinion on the financial statements, Government Auditing Standards require the auditor to report on the organization's internal controls over financial reporting and compliance with laws and regulations.

In order for this to occur, the auditor must obtain an understanding of the organization's internal control

environment, assess the design of internal controls, and test appropriately designed controls that reduce the risk of material misstatements (i.e., control risk). The auditor then uses the results to, among other things, determine the nature, extent, and timing of further audit procedures (e.g., substantive testing and tests of compliance). As noted in Figure 6, the higher the reliance the auditor can place on internal controls, the lesser the amount of substantive procedures that must be completed.

Therefore it is usually beneficial for organizations to implement, identify, document, and assess its internal controls over financial reporting. This will facilitate the most effective and efficient financial statement audit, improve

the organization's ability to obtain an unqualified opinion, and directly reduce the cost of the audit.

It is important to note that the process of implementing, identifying, documenting, and assessing the Organization's internal controls over financial reporting provides a wide range of benefits to the organization, ranging from a better ability to achieve the organization's missions and program objectives to an ability to seamlessly comply with the multitude of laws, regulations and directives applicable to DoD organizations.

What is a Control Activity and how do I distinguish between a Control Activity and a Business Process?

Control Activities are the policies, procedures, techniques, and mechanisms that help make certain that management directives are carried out. Control activities include: business performance reviews; controls over information processing (e.g., application controls and IT general controls (ITGCs); physical controls; and segregation of duties).

Organizations should identify control objectives for each type of control that, if achieved, would provide the organization with reasonable assurance that individual and aggregate misstatements (whether caused by error or fraud), losses, or noncompliance that is material to the financial statements would be prevented or detected¹. The Department's FIAR Guidance defines these as key control objectives (KCOs).

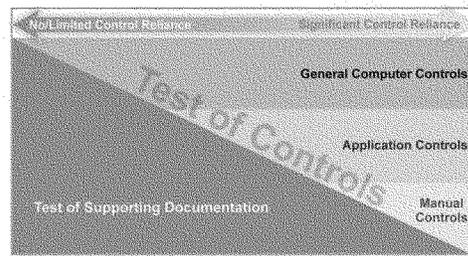


Figure 6: The higher the reliance the auditor can place on internal controls, the lesser the amount of substantive procedures that must be completed.

¹ GAO/PCTE EAM, 330-01 Identify Control Objectives

Business Process	Business Sub-Process	Sub-process Risk	Control Objective	Control Activity
Civilian Payroll	Payroll Computation	Payroll may be calculated inaccurately	Salary and benefits are calculated, paid, and recorded based on applying appropriate data from accurate formulas, calculations, and/or data processing	Payroll technicians will review the report which identifies payments less than \$1 and greater than \$5,000/\$10,000 for civilians on their respective databases and review their payroll system records to determine whether there are valid payment. If the net amount for each employee/item is greater than \$5,000/10,000 or less than \$1, the report is annotated and updates are made in the payroll system for any invalid payments
Civilian Payroll	Payroll Computation	Invalid payroll payments may be made to employees	Only valid payroll disbursements and collections are included in the outlays section of the Statement of Budgetary Resources	Payroll technicians will review the Master Pay History and Master Employee Record, in both databases, for each employee on the duplicate Social Security number listing to determine if an overpayment exists and if the employee should be separated

Figure 7: Examples of business processes, sub-process, risks, control objectives and control activities.

Business processes consist of any sequence of activities (transactions) that takes place in order to get work accomplished and achieve the business's objectives. These may range from a simple procedure, such as paying an invoice, to a key element of the business operations, such as processing civilian pay and purchasing missiles and satellites. They may also include functional processes, such as maintaining an organization's financial records, to cross-functional processes, such as an application of human resources.

In short, business processes are activities that are carried out in the normal course of business in order to achieve the objectives and mission of the organization. They should not be confused with control activities, which are the procedures put in place by

management to ensure that business processes are carried out as directed, while providing the organization with reasonable assurance that misstatements will be prevented or detected.

Figure 7 provides additional examples of these concepts.

What are Key Controls?

Key control activities are characterized by one or more of the following:

- Management relies upon them to prevent or detect material misstatements in financial reporting;
- They address relevant financial reporting assertions for a material activity (e.g., a financial report line-item); and/or
- They mitigate one or more significant control risks, such as fraud and inaccuracy.

It is important that management identifies those controls that are key to its financial reporting process and related transactions. The benefits of identifying key control activities are twofold: it allows the organization (during audit readiness) and the auditor (during the audit) to specifically target their testing efforts on controls that reduce the risks of material misstatements in the financial statements. This increases the effectiveness and efficiency of both processes, lowering costs and reducing the impact on personnel. In addition, and more importantly, the identification of key controls helps the organization identify: 1) controls that are not key, which will spur efforts to correct them; and 2) duplicate and/or redundant controls which, by their elimination, improve the efficiency of the organization's programs.

Financial Statement Assertion	Definition
Existence and Occurrence	Assets, liabilities, equity interests and budgetary resources exist, and all revenue and expense activity actually occurred
Rights and Obligations	The Organization holds or controls the rights to assets, and liabilities are the obligations of the organization. All revenue, expense, and budgetary transactions pertain to the organization
Completeness	All assets, liabilities, equity interests, revenue/expense transactions, and budgetary activity that should have been recorded have been recorded
Valuation	Assets, liabilities, equity interests, revenue/expense transactions, and budgetary activity are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded
Presentation and Disclosure	Financial information is appropriately presented and described and disclosures are clearly expressed. All financial and other information is properly disclosed

Figure 8: Definitions of financial statement assertions.

Mapping control objectives to control activities and then to financial reporting assertions are the first steps in determining which internal control activities are key control activities. “Non-key” control activities, while useful, may not provide an essential degree of assurance on the effective mitigation of the significant risks impacting a key business process. Some common examples of key control categories include:

Segregation of Duties – Segregation of duties is effective when the responsibilities for a financial process are separated between various individuals within an organization. The same

individual should not be authorized to approve an accounts receivable transaction, enter it into the system, and then bear responsibility for reconciling the transactions. Proper segregation of duties will prevent individuals from being able to misappropriate assets.

Authorizing Procedures – An authorization control is effective when more than one person is responsible for authorizing a decision or action that can impact the organization's assets or financial statements. On the other hand, an excessive number of transaction approvers may indicate an inefficient control. For example, a supervisor review and approval may be required over reconciliations performed.

In addition to these key control categories, key controls themselves relate to the input, processing and output activities that help an organization achieve the financial statement assertions represented in Figure 8 above. In representing that their financial statements are fairly presented in conformity with generally accepted accounting procedures, Organization management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure. In essence, Organizations make the following specific assertions regarding their financial statements as represented in Figure 8 table above.

How do I use a SSAE 16 Report on Controls at a Service Organization?

According to the FIAR Guidance and Generally Accepted Government Auditing Standards (GAGAS), an organization's management is responsible for the internal controls over their financial information and, therefore, must ensure that they understand which financially significant activities are outsourced to service providers. Additionally, GAGAS defers to the American Institute of Certified Public Accountants (AICPA) Statement on Standards for Attestation Engagements (SSAE) Number 16 as the authoritative standard for the audit of a service organization. Accordingly, the organization's management is ultimately responsible for the effectiveness of the service providers' controls over those activities that impact the organization's financial reporting. As an organization commences its audit readiness efforts, it needs to identify activities being performed on its behalf by service providers. In these cases, an SSAE 16 report should be obtained when available to reduce the organization's audit

readiness work over service provider activities. Based upon our experience, one best practice is for the organization and the service provider to identify the key controls that will be included in an ultimate SSAE 16 report and assign roles and responsibilities at that granular level. This significantly reduces the cost of an SSAE 16 engagement, because it gives all parties involved a clear expectation of the audit scope.

In evaluating whether an SSAE 16 report provides sufficient evidence about the effectiveness of internal controls at the service organization, organizations should consider the following factors:

- The time period covered by the tests of controls and its relation to the period under evaluation by management. Alternatively, the date of management's assertion over the assessable unit under evaluation should be considered;
- The scope of the SSAE 16 examination and applications covered, the controls tested, and the way in which tested controls relate to the organization's controls;
- Whether the report identifies controls over the service organization's activities that support relevant financial statement assertions at the organization;
- Whether the report includes both an evaluation of the design of controls and tests of operating effectiveness (i.e., a SSAE 16 Type II report);
- The results of those tests of controls, as well as the service auditor's opinion on the operating effectiveness of the controls and whether each control objective was achieved;
- Whether significant changes that have occurred at the service provider between the SSAE 16 report date and the organization assertion date have been identified and addressed;
- The impact that the results of tests of control have on the assessment of internal controls by the organization; and
- The service auditor's professional reputation and competency.

How do I get started?

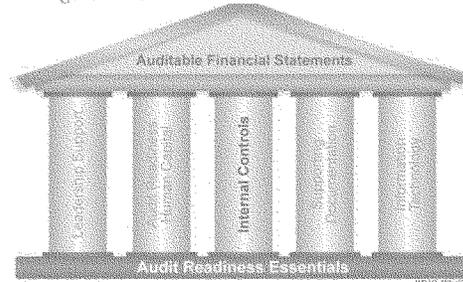


Figure 9: Organizations should implement, identify, document, and assess their internal controls over financial reporting.

As part of their audit readiness efforts, organizations should implement, identify, document, and assess their internal controls over financial reporting as shown in Figure 9. Consistent with the FIAR Guidance, the following steps should be taken to accomplish this goal:

Step 1: Identify your Financial Processes. The first step is to identify your financial processes (including assessable units, sub-units, transactions, accounts, and related financial systems and dollar values associated with each financial process). This serves as the foundation for the next steps in the process.

Step 2: Identify your Significant Processes. This task is aimed at identifying which of the financial processes (including assessable units, sub-units, transactions, accounts, and related financial systems, identified in Step 1 above) are significant to the organization's financial reporting, based on quantitative (dollar value) and qualitative (non-financial) considerations. In order to determine materiality, organizations should review the guidance provided by OMB Circular A-123 and the PCIE/GAO FAM.

Step 3: Prepare Process and Systems Documentation. Once significant processes have been identified, process and related system documentation must be developed. The process and system documentation should include information covering the initiation, authorization, processing, recording and

reporting of the transactions associated with each significant process. The documentation should also include risks associated with the significant processes and related controls. Controls should be noted as such to facilitate the performance of the steps that follow.

Step 4: Identify Risks, Key Control Objectives and related Key Controls. Based on the information gathered through the development of process and system documentation, the organization should develop control worksheets (sometimes referred to as a control matrix) that identify risks, key control objectives and related financial statement assertions, as well as controls in place to mitigate the risks and address the objectives. This document will allow the organization to: 1) identify those risks that have not yet been mitigated by an existing control, 2) identify and eliminate redundant controls, and 3) assess the design of controls.

Step 5: Assess the Design of Controls. The control worksheets may be used to facilitate the organization's assessment of the design of controls. Only appropriately designed controls should be tested for effectiveness. The assessment of the design of controls should focus on how well the control addresses the key control objectives (RCOs) and relevant financial statement assertions. Appropriately designed controls that address key control objectives over significant processes are typically deemed key controls. Controls that are not appropriately designed should

be noted as such and corrective actions must be developed and executed.

Step 6: Develop and Execute Tests of Controls. Organizations should establish a supportable approach to tests of controls. The approach at a minimum should include the following steps:

- Identify the controls to be tested – Only test appropriately design controls.
- Avoid duplication of efforts with other similar activities – Coordinate with similar activities such as FFMIA, GPRA, IPRA, FISMA etc.
- Identify who will perform the testing – Engage personnel who possess the necessary competence and objectivity.
- Develop and execute test plans – Formal tests plans should be developed to facilitate review and approval by interested parties. The execution of the tests plans should include the consideration of the nature, extent (including sampling techniques), and timing of the testing. Testing should be stringent and extensive enough to allow for reliance by the organization's management and sufficient to support management's SSAE 16 assertion. Within the Federal government, the recognized assessment methodology is summarized in the GAO/President's Council on Integrity and Efficiency (PCIE) Financial Audit Manual (FAM) (Section 450) and GAO FISCAM. In addition, OMB Circular A-123 includes guidance on internal controls sample sizes based on the frequency of controls. Organizations should move to adopt the testing methods outlined in these publications.

e. Document test results – Documentation should include the identification of items tested and who performed the tests, test results, and the overall conclusion.

Step 7: Summarize Test Results and Categorize Deficiencies. Once the testing is complete, organizations must summarize and evaluate the results of the tests. In accordance with OMB Circular A-123, Organizations must categorize deficiencies as a Control Deficiency, Significant Deficiency, or Material Weakness.

Step 8: Develop and Implement Corrective Actions. For any material/significant deficiencies noted during testing, organizations must design and implement corrective actions.

Supporting Documentation

Commonly asked questions:

- Why do I need supporting documentation?
- What is "sufficient, appropriate" supporting documentation?
- What documentation do I need to support financial statements?
- How do I get started?

Introduction

When organizations assert audit readiness, they are declaring that their financial statements are prepared in accordance with Generally Accepted Accounting Principles (GAAP); a set of standards to help ensure that financial events are consistently recorded, accumulated, and reported in financial statements. Per Statement of Auditing Standard (SAS) No. 103 / AU 326 Audit Evidence, "Management is responsible for the preparation of the financial statements based on the accounting records of the entity." In other words, supporting documentation is comprised of electronic and hard-copy evidence that supports the amount, classification, summarization, and reporting of an organization's individual business events in its financial statements.

Why do I need supporting documentation?

Financial statement auditors are required to obtain audit evidence in order to draw reasonable conclusions by performing audit procedures to:

1. Test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as tests of controls); and
2. Detect material misstatements at the relevant assertion level (audit

procedures performed for this purpose are referred to as substantive procedures and include tests of details of classes of transactions, account balances, and disclosures, as well as substantive analytical procedures).

Auditors performing testing to "detect material misstatements" may select samples of transactions and records underlying the financial statements. For each sample item, the reporting entity must provide supporting documentation for the individual transactions to demonstrate that the financial event was accurately recorded in the accounting/subsidiary system, and ultimately in the financial statements. The organization must provide supporting documentation to the auditor to prove there are no material misstatements in their financial statements by showing that individual transactions and balances are accurately recorded, accumulated, and reported in the financial statements.

What is "sufficient, appropriate" supporting documentation?

Organizations should consider the auditor's requirements. In other words, what is "good enough for the auditor"? Auditors are required to review sufficient, appropriate supporting documentation to allow them to draw conclusions on whether any material misstatements exist in an organization's financial statements. The audit standards explain that sufficiency is the measure of the quantity of supporting documentation. Appropriateness is the measure of the quality of supporting documentation; that

Auditor Requirement:	Example:
Supporting documentation is more reliable when it is obtained from knowledgeable independent sources outside the reporting entity.	When gathering supporting documentation for Fund Balance with Treasury (FBWT) activity, the auditor will place greater reliance on reports obtained from the Treasury than on internally generated reports from the organization's accounting system.
Supporting documentation that is generated internally is more reliable when the related controls imposed by the reporting entity are effective.	Requests for Personnel Actions (SF-52s) created and stored electronically in the personnel system are more reliable if the auditor has comfort that the controls over the personnel system are operating effectively.
Supporting documentation obtained directly by the auditor is more reliable than supporting documentation obtained indirectly or by inference.	The auditor will place greater reliance on payroll information obtained directly from the service provider than on payroll information obtained from the organization (which, in turn, may have obtained the information from a service provider).
Original supporting documentation is more reliable than documentation provided by photocopies or facsimiles.	Auditors will place greater reliance on original deeds that demonstrate rights to land than on photocopies of the deeds.

Figure 10: Key Indicators used by auditors to evaluate the sufficiency and appropriateness of supporting documentation.

is, its relevance and reliability in providing support for or detecting misstatements in the classes of transactions, account balances, disclosures, and related assertions.

An auditor's view on the reliability of supporting documentation is influenced by the source and nature of the documentation, and is dependent on the individual circumstances by which the supporting documentation is obtained.

Figure 10 shows the key indicators used by auditors to evaluate the sufficiency and appropriateness of supporting documentation.

In summary, the auditor uses many factors when evaluating the sufficiency and appropriateness of supporting documentation. Organizations should keep these factors in mind when performing their audit readiness work.

What documentation do I need to support financial statements?

Organizations must be certain they can support relevant financial statement assertions for transactions and balances, along with supporting documentation. Specifically, they must identify the documents they will use to support each material transaction type and balance. A simple method to ensure that relevant assertions are addressed is to prepare a Supporting Documentation Matrix. Figure 11 is an example of a Supporting Documentation Matrix for the Appropriations Received line of the Statement of Budgetary Resources.

Line Item	Key Supporting Documents	Financial Statement Assertions				
		Existence	Completeness	Valuation	Presentation & Disclosure	Rights & Obligations
Appropriations Received	1. Apportionment and Reapportionment Schedule (SF 132)	X	X	X	X	X
	2. Report on Budget Execution and Budgetary Resources (SF 133)				X	
	3. Year-End Closing Statement (FMS 2108)				X	X
	4. Trial balance by fund code (Treasury account) corresponding to each appropriation				X	
	5. Funding Authorization Documents (FADs) supporting departmental allotments					X

Figure 11: Example Supporting Documentation Matrix.

How do I get started?



Figure 12: Consistent with the FIAR Guidance, Organizations should evaluate their supporting documentation following the FIAR methodology.

Understanding the auditor's requirements surrounding supporting documentation will allow organizations to understand the "bar" that they need to clear to become auditable. With that understanding in mind, organizations should follow a series of repeatable steps for material assessable units/financial statement line-items. Consistent with the FIAR Guidance, Organizations should evaluate their supporting documentation following the FIAR methodology shown in Figure 12. These steps include:

Step 1: Define the population and reconcile it to the general ledger. For each material financial statement line-item, the organizations must extract a population of transaction-level activity and reconcile that population to their general ledger. If no trial balance is available from the general ledger, an equivalent report (e.g., DFAS 218 Report) should be used to demonstrate that the population contains transactions that accumulate to amounts reported in the financial statements. Any differences between the population and the general ledger must be identified and appropriately resolved.

Step 2: Define Key Supporting Documents (KSDs) and document retention requirements. After preparing the population, organizations should identify the documentation needed by transaction type to support the relevant financial statement assertions. This can be accomplished using a Supporting Documentation Matrix to visually demonstrate how assertions are addressed. After relevant KSDs are identified, organizations should confirm that their existing document retention policies are sufficient, requiring field locations to retain KSDs for a sufficient period of time to support current balances and transactions in their financial statements.

Step 3: Develop tests of supporting documentation. Organizations should then develop a test for the existence of supporting documentation and the organization's ability to retrieve such documentation in a timely manner. This includes designing a representative sample of the population, defining what specific documentation will be required for each type of sample item, and

summarizing the comparison procedures that will be performed between each sample item and the documentation supporting the sample item (to verify the accuracy/classification of the transaction as recorded in the system).

Step 4: Execute tests of supporting documentation. After the test has been developed, the organization must execute the test, select the sample items, and complete testing on sample items in the population. Any instances in which documentation could not be located or the recorded sample items did not agree with supporting documentation should be noted for evaluation.

Step 5: Summarize results and categorize deficiencies. Once the testing is complete, organizations must evaluate the results of the tests. Exceptions should be summarized by type and evaluated. Errors caused by missing documentation and data input should be separately considered and examined for trends and root causes. For deficiencies that are greater than insignificant or isolated, organizations should proceed to Step 6.

Step 6: Develop and implement corrective actions. For any material/significant deficiencies noted during testing, organizations must design and implement corrective actions. For instances in which original source documentation cannot be located, organizations must identify alternative documentation, and then perform tests to confirm the existence of the alternative documentation. For instances in which transactions and balances are not consistent with the supporting documentation, organizations should identify the root cause of the error, make necessary process/control improvements to prevent such errors in the future, and review the current population to ensure similar transactions in the population are corrected.

Information Technology

Commonly asked questions:

- How do I know which systems to include in my audit readiness efforts?
- What IT control objectives need to be addressed?
- Will my existing certification, accreditation, and compliance-related documentation satisfy audit readiness requirements?
- How do I get started?

Introduction

As reporting entities begin their audit readiness efforts, they need to identify systems that should be evaluated for effective internal controls. Reporting entities should compile an inventory of systems used in end-to-end processes to record, process, and report transactions. Additionally, reporting entities should identify any ERPs, feeder systems, and micro-applications used to create and store supporting documentation. This information is typically gathered during interviews, end-to-end walkthroughs of transactions, and inspections of available documents that describe the systems environment. These documents could include, but are not limited to, system certifications and accreditations, system security plans, interface agreements, and system inventories prepared to comply with the Federal Information Security Management Act of 2002 (FISMA).

How do I know which systems to include in my audit readiness efforts?

Once an inventory of systems has been compiled, a reporting entity must ask three specific questions for each system in the inventory:

- 1) Does the system perform a key automated control? Examples include user access to perform transactions, checking for data completeness/accuracy, and matching of invoices to receiving documents.
- 2) Are key manual controls dependent on reports or data generated from the system? Examples include reports used to perform physical inventories, exception/error reports of rejected transactions, and reports or data sets used to perform reconciliations.
- 3) Are Key Supporting Documents (KSDs) created/retained in the system? Examples include electronic timesheets, receiving reports, and purchase orders.

If a reporting entity answers yes to one or more of these questions, the system should be scoped into a reporting entity's audit readiness efforts.

It is important to remember that these systems may be financial systems, mixed systems, or potentially non-financial systems (e.g., personnel, equipment maintenance, etc.). The appropriate scoping in/out of systems in audit readiness efforts will help ensure that appropriate resources are effectively utilized and time is not wasted reviewing systems that are not key. Resources should be focused on systems that need to be scoped into audit readiness efforts.

What IT control objectives need to be addressed?

Once an organization has established which systems are in-scope for internal controls over financial reporting and audit readiness, reporting entities need to determine which IT controls to evaluate. There are two basic levels of IT controls:

Application Controls: These are controls that are specific to individual transaction processes within a system. An example of an Application Control is a system that requires a "Travel Order Approver" role in order for a travel order to be approved and processed in a system. This is referred to as an application control because it is specific to the travel system application and does not relate to approving timesheets in the time and attendance

system. Application controls are grouped into the following categories which can affect the reliability of financial data:

- Business Process Controls
- Interface Controls
- Database Management System Controls
- Application-Level General Controls

IT General Controls: These are controls that relate to the overall functioning of an individual application or a group of applications. For example, the program configuration management (software change control) process for an individual application has the potential to impact automated control features built into the system. The configuration management process for a computer system that serves as the platform for multiple applications has the potential to affect the integrity of applications that run on that platform. IT general controls are grouped into the following categories which can affect the reliability of financial data:

- Security Management
- Access Controls
- Segregation of Duties
- Configuration Management
- Contingency Planning

The GAO Federal Information System Controls Audit Manual (FISCAM) is the primary authoritative source for evaluating IT controls during a financial statement audit. It provides details regarding relevant control objectives,

control activities, and control techniques. The IT control areas documented in FISCAM are also consistent with the CFO Council's implementation guide for OMB Circular A-123 (Appendix A).

Will my existing certification, accreditation, and compliance-related documentation satisfy audit readiness requirements?

In short, the answer is, "it depends." While the areas and requirements addressed by certification, accreditation, and other compliance assessment work completed by the organization may align with certain FISCAM control objectives, activities, and techniques, the controls design documentation, testing procedures, and testing results are typically not prepared in a manner that addresses OMB Circular A-123 (Appendix A) and Financial Improvement and Audit Readiness (FIAR) requirements. If your certification, accreditation, and compliance assessment efforts result in Yes/No or Compliant/Not-Compliant documentation and test results, you will realize very limited re-use for audit readiness preparations.

When planning your next certification and accreditation or compliance assessment effort, it is best to include controls documentation and testing requirements that meet audit readiness requirements. This will increase the auditor's ability to reuse the resulting work products.

How do I get started?



Figure 13: When controls are performed by an information system the system is in scope for audit readiness.

A few key steps that must be completed:

Step 1: Identify a team comprised of personnel who possess appropriate systems controls knowledge and experience. As discussed in the Audit Readiness Human Capital section of this document, it is critical for the audit readiness team to incorporate personnel who possess Federal financial statement audit experience. Specifically, the team should include specialized information technology auditors who have experience applying the GAO FISCAM to financial statement audits. Furthermore, it may be necessary to identify IT auditors who possess specialized application (e.g., ERP) and/or hardware platform (e.g., client server or mainframe) technical experience.

Step 2: Identify which systems impact internal controls over financial reporting. As noted in the Internal Controls section of this document, the audit readiness team should identify the organization's significant financial processes and related risks, KCOs, and key controls. In those instances where the controls are performed by an information system or are dependent on reports and data produced by an information system, the

system is in scope for audit readiness, as shown in Figure 13. Close collaboration between the information technology audit specialists and other members of the audit readiness team is essential to correctly address this key scoping question.

Step 3: Establish the control objectives against which the system application and general controls will be evaluated. As the GAO FISCAM was developed for multiple types of information system audits (financial and non-financial), only a subset of the FISCAM control techniques is typically relevant for audits of Federal financial statements. Input from information technology audit specialists who have experience applying the FISCAM on Federal financial statement audits should be considered in this decision-making process.

Step 4: Determine which organization(s) are responsible for performing relevant systems-related functions. After determining which information systems and FISCAM control techniques are in scope, it is necessary to identify the organization(s) that have responsibility for relevant aspects of information systems management. This may include one or more external service providers or third-

party service organizations. In the DoD environment it is not uncommon for the user organization to rely on one service provider for application development/maintenance (e.g., DFAS, BTA, CPMS) and another for data center operation and application hosting (e.g., DISA). These entities may be responsible for performing relevant internal controls and/or retaining Key Supporting Documentation (KSD).

Step 5: Document the controls, perform tests of design and operating effectiveness, and evaluate the results. Consistent with the Internal Controls section of this document, the audit readiness team would gather the information needed to determine the procedures in place to meet the FISCAM techniques for each in-scope system. The identified controls for each FISCAM technique would be documented in a summary format and evaluated to determine whether the applicable FISCAM techniques, activities, and objectives are adequately addressed. This is typically referred to as a test of design effectiveness and should be completed before more rigorous and time-consuming tests of operating effectiveness are performed. For those controls upon which reliance is being placed and are effectively designed, tests of operating effectiveness are performed. These typically involve selecting samples and testing the actual performance of the controls over a period of time (usually six months to one year). After completing the tests of design and operating effectiveness, management should evaluate the results, make a determination on the reliability of the information systems controls and their impact on audit readiness, and implement corrective actions as necessary.

If management has any questions regarding the results from each phase, input should be obtained from appropriate knowledgeable sources before moving on to the next step. Following this approach will help management avoid issues involving scoping, adequacy of documentation, appropriateness of conclusions, and preventable re-work.

Conclusion >

In conclusion, the CFO Act and GMRA require Federal Executive Agencies to prepare financial statements and have them audited by independent auditors. More recently, the Defense Authorization Act also required that the DoD and other Departments demonstrate audit readiness progress and be prepared to sustain a full scope financial statement audit by FY 2017. These requirements can be met if the DoD Organizations apply the audit readiness principles addressed in this guide as shown in *Figure 14*.

Organizational Leadership Support is critical to create a synergistic culture that influences the organization to work together to achieve success. Audit readiness success is dependent on more than just financial management support, it requires leadership support from across the organization to ensure that information systems, business processes, internal controls, logistics, and supporting documentation are all working together to properly record business events in the financial statements.

Appropriate Audit Readiness Human Capital requires the right people with the right skills, training, education, and experience to identify audit readiness impediments and develop workable solutions. Congress understands this need and has written into the FY 2012 Defense Authorization Act that the DoD must document audit readiness skills and education.

Effective Internal Controls demonstrate an organization's ability to assert that its financial statements are fairly stated in accordance with Generally Accepted Accounting Principles (GAAP). The scale of the operations of the DoD and its organizations is so large that

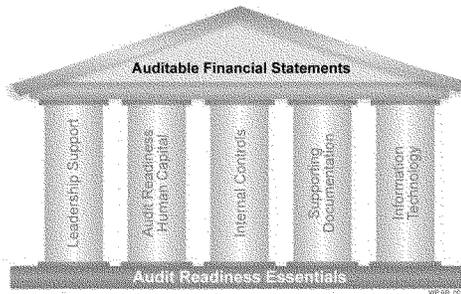


Figure 14: These Audit Readiness competencies can be met if the DoD Organizations apply the audit readiness principles addressed in this guide.

it would be cost-prohibitive to audit the Department's financial statements without relying on internal controls. Therefore, internal controls procedures that are properly designed, implemented, and maintained are an essential audit readiness competency that is necessary to enable the DoD and similar organizations to achieve reliable financial reporting, effective and efficient operations, and full compliance with laws and regulations necessary to sustain a full-scope financial statement audit.

Adequate Supporting Documentation must be produced to allow auditors to form conclusions on the fair presentation of the financial statements. Government auditing standards require that auditors obtain sufficient and appropriate supporting documentation to form conclusions to support their audit opinion. This supporting documentation, which may

be comprised of electronic and hard-copy evidence, will be used to support each financial statement assertion and support the amount, classification, summarization, and reporting of individual business events.

Reliable Information Technology controls within and surrounding organizational systems improve the ability of management and auditors to rely on electronic data used to prepare the financial statements. Organizations must include relevant ERP's, feeder systems, and micro-applications in their audit readiness plans to ensure that data processed by or obtained from information systems can be relied upon for both audit and operational purposes. Strong information technology controls lead to greater efficiencies and cost savings in current and future audit readiness efforts and will reduce the cost of future financial statement audits.



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