

Department of Defense Audit Impediments and Audit Readiness Testimony

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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) ((OUSD(C))), 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.