



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

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

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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."<sup>1</sup>

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

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<sup>1</sup> 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.<sup>2</sup>

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

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<sup>2</sup> 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.

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