DEFENSE BUSINESS BOARD

Financial Audit Strategy Task Group

Final Report
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DBB Task Group

Bill Phillips (Task Group Chairman)

Neil Albert

Bob Hale

Jim Kimsey

Andrew Siegel

Kelly Van Niman (DBB Deputy Director)

DoD Liaisons

Gene Reardon, Office of Inspector General, Department of Defense, Auditing

Jonathan Witter, OUSD (Comptroller), Accounting and Financial Policy and Analysis Directorate

In support of DoD's goal to achieve a clean audit opinion by 2007, the DBB was asked to develop recommendations benchmarked on best practices related to the following:

Terms of Reference Objectives

1. *Resourcing*: A strategy for ramping up and training staff; funds management

2. *Communications*: A strategy to communicate, internally and externally, key audit themes

3. *Roles and responsibilities*: Recommendations with respect to the interaction between DoD management and external auditors, and the role of an "audit committee"

- **Background info gathered at Industry Days held by DoD/IG**
- **Interviewed individuals in the DoD/IG and OUSD/(Comptroller)**
- **Interviews with sources possessing financial audit expertise:**

Public Sector
- Department of Energy
- Department of Homeland Security
- GAO
- U.S. Coast Guard
- Pennsylvania State Deputy Auditor

Private Sector
- Capital One
- LCC International

Accounting Community
- KPMG
- PWC

- Observations from Private Sector Interviews
- Observations from Public Sector Interviews
- Task Group Observations on the DoD Process

Observations from Private Sector Interviews

- Audit is part of business culture – a year-round, constant process
- Focus is on internal controls first – they drive internal staffing and external hiring (auditors) requirements and costs
- Communication and coordination among external auditor, CFO organization at headquarters and the field are essential to success
- Sarbanes-Oxley requirement for two audits is driving up costs and stressing already scarce resources
- Audit firms concerned about finding necessary quantity/quality staff
  - DoD must show commitment before they will hire/train
- Audit firms concerned about independence & impact on future work
- Audit firms rely on CFO organization/audit teams to do extensive preparation work (schedules and data)
  - DoD doesn't have this audit team

Observations from Public Sector Interviews

- Senior Departmental leaders and Congress must be convinced that audit money is well spent
- Success can depend on having a single official with the responsibility and authority to direct needed actions
  - Must balance and justify operational and audit requirements
- General reliance on internal team(s) rather than formal audit committee
  - HQ team comprised of CFO rep, field CFOs, external auditors
  - Teams replicated throughout the organization/field (include operational/program reps)
  - Teams must meet regularly (weekly during peak season)
- Competition can be used to create incentives; results are tracked

Task Group Observations on the DoD Process

- CFO, DoD/IG and GAO cooperating and addressing issues faced by other agencies who have already undergone financial audits
  - Comptroller's business rules under the Financial Improvement Initiative clearly define roles and responsibilities and provide discipline and governance to Comptroller's audit plan (see Appendix A for summary) but DoD/IG has not agreed with all aspects as written by Comptroller.
- DoD has made considerable progress to date
  - It can all fall into place with proper leadership/attention from the top
  - DoD has not adequately lobbied Congress for financial resources to support the full audit process (both preparation and actual audits)
  - Risk DoD may engage in heroic efforts to "create" clean opinion on FY07 FSs. This is ultimately of little real value for the cost incurred.
- Concerned that audit will be last priority since entity is paying for audit and entity's audit plan is not tied to the entity's balanced scorecard or individual/manager performance measures

Major Recommendations

Highlights

- Create an integrated strategic plan
  - Focus on intermediate goals
- Step up communications effort
  - SECDEF involvement
  - Clear, simple themes to "sell" audit
- Align people and money to the plan
  - Centralize management of funds to support audit preparation and audits
  - Syncronize resources to strategic plan
- Improve audit governance process
  - Create senior advisory group to help "sell" audit

1. Develop An Integrated Strategic Audit Plan* for the Entire Department. Critical Elements:

- **Set more realistic objectives**
  - Achieving an unqualified audit opinion (UAO) on all the 2007 financial statements is unrealistic
  - Plan should set achievable long-term goal but focus on intermediate goals and milestones
    - Intermediate goals should be of sufficient importance to convince Congress and others of progress
    - Examples of intermediate goals: Achieve UAO for a designated service; achieve UAO for a designated statement (e.g. Statement of Budgetary Resources); resolution of GAO documented material weaknesses
    - Highlight and leverage early successes
  - Coordinate objectives with internal and external stakeholders

** "Audit plan" refers to all aspects of achieving clean opinion, not just audit*

1. Strategic Audit Plan Critical Elements (continued):

- **Must be developed and executed jointly by the DoD IG and the USD (Comptroller):**
  - Must address all key aspects of the audit process including planning, resource allocation, preparation, execution, and the analysis of results
  - Must reconcile roles and responsibilities stated in proposed business rules (Appendix A)
  - Include set of performance/progress metrics
  - Need ongoing commitment to cooperation across the Department
  - Incorporate the communication plan with emphasis on importance and purpose of the audit
    - Requires significant attention to ongoing “selling” audit process at senior levels of the Department

1. **Strategic Audit Plan Critical Elements (continued):**

- **Manage and publicize compliance using red/yellow/green "stoplight" approach**

- **Share results on regular basis with Senior Leadership:**
  - Present to Service Secretaries and Agency heads as well as OSD
  - Tie to balanced scorecard

- **Align objectives of the Business Management Modernization Program (BMMP) and intermediate audit plan goals**
  - For initiatives associated with achieving a clean audit opinion

2. Step-Up Communications in Support of the Audit Objectives. Critical Elements:

- **Secretary of Defense should personally communicate the importance of the audit plan:**
  - Ask that he state importance in memos, testimony, speeches, and highlight success and milestone accomplishment along the way
  - Tie audit plans to President's Management Agenda, the Department's Balanced Scorecard, and BMMP
  - Drive performance through performance metrics, balanced scorecards and merit pay incentives

2. Communications Critical Elements (continued):

- **CFO should regularly communicate importance of audit plan:**
  - Develop two or three simple, convincing themes to sell the audit plan at all levels in the civilian and warfighting communities
    - Possible themes: "DoD must have clean audit to assure public that they are good stewards of funds"; "Process facilitates better financial information which in turn will lead to better management decisions; "Need to comply with the law".
  - Use themes often and consistently in all communication vehicles

- **Establish an outside senior advisory group to help "sell" audit to stakeholders**
  - See Recommendation #4, "Improve Governance Process " for details

3. Employ Smart Resource Planning. Critical Elements:

- **Look for flexibility to handle inevitable shifts in demand for audit services:**
  - Utilize staff sharing between IG and Service audit teams to build skills and process understanding (government personnel)
  - Leverage cross-training and coordinated assignments
- **Tie resource acquisition to the key milestones in the integrated strategic audit plan**
- **Manage workload to support gradual buildup of contractor audit workforce:**
  - Use contracts with options to manage buildup
  - If assessment/audit work not available, loan auditors to the Services/agencies to do correction work
- **Conflict-of-interest/independence issues to be managed on an on-going basis (Key job for DoD/IG Program Mgt Office)**

3. Resource Planning Critical Elements (continued):

- **Money – Ask Congress for authority to centralize the management of audit related funds within the USD (C):**
  - Facilitates management tradeoffs on audit related activities – facilitate smart investing of limited resources
  - Provides means to reward early successes by financially supporting activities
  - Helps eliminate spending where it won't yield required results
  - Funds for audit will not compete well within services
- **Offer merit pay incentives for on-time and early successes**

4. Improve Governance Process. Critical Elements:

- **Establish an outside senior advisory group *to help "sell" audit*:**
  - Very senior chair (lends credibility to effort) and members chosen for ties to groups that need to support the audit: Capitol Hill, Flag Officers, commercial audit firms
  - Objective: to help in communications with key stakeholders and to provide the DoD leadership with rapid professional advice on implementation challenges and long-term strategic guidance on audit-related plans and programs
  - DBB can help formulate charter, options to establish this group and suggest a list of potential members (See Appendix D for suggested charter and next steps)

4. Governance Process Critical Elements (continued):

- **Elevate stature and composition of DoD Audit Committee**
  - Deputy Secretary as Chair (COO if created)
  - Principals' attendance required to emphasize and communicate necessary roles and responsibilities of DoD senior leadership

Next Steps

- Present final report to Senior Executive Council (SEC).
- Present final report to the Secretary of Defense for approval and action.
- DBB will be available to support follow on tasks resulting from this report, such as guidance on the establishment of an outside senior advisory group.

Appendices

Appendix A

Business Rules for Current Audit Process

Financial Improvement Initiative - Proposed Major Phases

PROPOSED DISCOVERY AND CORRECTION PHASE

Purpose

- Identify obstacles to unqualified audit opinion
- Prepare improvement plans with measurable solutions
- Complete corrective actions
- Prepare business case for and complete systems modifications (business case sent to Business Management Modernization Program office)

Roles/Responsibilities

- Entities/components develop and execute improvement plans, giving priority to most material impact
- Internal and external auditors provide consultation
- Management and entity audit committees monitor progress

PROPOSED VALIDATION PHASE

Purpose

- Validate corrective action
- Determine if sufficient controls & transaction info are available to support management's assertion that line item or statement is ready for audit or assessment first

Roles/Responsibilities

- Entity notifies IG of intent to validate and method (copy to OUSDC)
- IG may advise entity on validation methodology
- OUSDC notifies Review and Prioritization Subcommittee, which notifies Executive Steering Committee – if any concerns ESC conveys those to entity
- Entity's management responsible for review and may use internal auditors, internal management or external auditors
- Work may be used by IG if management says ready for audit/assessment

PROPOSED ASSERTION PHASE

Purpose

- Notify IG of validation of corrected deficiency and ready for audit

Roles/Responsibilities

- Entity's management prepares Assertion Letter / package and submits to IG, copy to OUSD(C) Review & Prioritization Subcommittee (RPS)
- Entity prepares engagement letter and management representative letter for IG
- IG makes determination whether to audit or assess; notifies RPS
- RPS reviews and prioritizes improvement plans, representation letters, IG recommendations and makes prioritization recommendations to ESC
- ESC approves assessment/audit required before IG, DoD obligates funds for assessment/audit contracts.

PROPOSED ASSESSMENT PHASE

Purpose

- Assess reliability of management's assertion
- Remediate deficiency, if found
- Accomplish audit steps outlined in Planning Phase and Internal Control Phase of the audit manual

Roles/Responsibilities

- ESC approves assessment
- IG or external auditor performs assessment
- External auditor writes report to management describing deficiencies, if any, and recommends remediation
- Entity may perform remediation if deficiency found, that would prevent an unqualified opinion
- IG will recommend when appropriate to move forward with formal audit

PROPOSED AUDIT PHASE

Purpose

- Obtain auditor's opinion on the condition of an entity's financial statement line or fairness of the presentation of the information in the financial statements

Roles/Responsibilities

- IG determines scope and nature of audit and associated reports
- IG oversight of IPAs
- With assistance of IG, components prepare engagement letters requesting audit services
- Components prepare interim management representation letters
- Components prepare final management representation letter
- IG will intervene if necessary to end the audit and recommend follow up assessment

Appendix B

Current Communication Plan
(before suggested changes)

Financial Improvement Initiative
Communications Strategy

CUSTOMIZED COMMUNICATION

1. OUSD(C) meetings (3 days) with Military Departments to conduct bottom to top review of reporting processes, review previous audit weaknesses, examine potential portions of financial statements for near term audit, and build strong multi-lateral coalitions between stakeholders.

Participants include:

- Military Department Financial Management Offices
- Auditors from the Audit Agency of the Military Department
- Auditors from the Inspector General
- Accountants from the Defense Finance and Accounting Office

STATUS

- Air Force — Complete
- Navy — Complete
- Army — Targeted for August/September

2. Distribute Memorandums from USD(C) Reinforcing Need for Cooperation

STATUS

- Army — Complete
- Navy — Complete
- Air Force — Complete
- Defense Agencies — Partially Complete

Financial Improvement Initiative
Communications Strategy

CULTURAL COMMUNICATION

Communicate and reinforce objectives and procedures in monthly audit committees.

STATUS

- Complete for audit committees currently operating.

MASS COMMUNICATION

1. Annual Financial Reporting Conference

   STATUS

   - Planned for last week of July. Session dedicated to FII.
2. Central information portal/web site for distribution of information including policies, procedures, metrics, and progress.

   STATUS

   - Pending resource availability. Expect contract support to assist with implementation during September-October time frame.
3. Monthly electronic newsletter to communicate highly critical news.

   STATUS

   - Pending resource availability. Expected to implement in September.
4. Articles in periodicals (e.g. Armed Forces Comptroller and other DoD magazines) to communicate rationale and inspire commitment.

   STATUS

   - Target publishing first periodical in fall 2004.

Appendix C

Current Governance Process
(before suggested changes)

DoD Audit Committee

- Members: 8 permanent members, 4 non-DoD federal officials (appointed by Chairperson for 2 year terms), representatives from DoD/IG and GAO (non-voting)

  Permanent Members: USD (Comptroller)/CFO (Chair), USD (AT&L), USD (P&R), Director (PA&E), Director Defense Finance and Accounting Service, one senior representative from Army, Navy and Air Force as appointed by Service Secretary

- Reporting/Meetings: Reports to Deputy Secretary, meeting at least once to monitor progress and identify issues regarding the audit.

- Scope and Responsibilities: Internal control and compliance; Department performance; financial report of the Department; other responsibilities as requested by Department Head; communications responsibilities

DoD Audit Committee

Scope and Responsibilities

Internal Control and Compliance

- Review management's assessment of the effectiveness of the Department's internal control and security, including financial performance information systems, and consider the adequacy of management's assessment.
- Review management's assessment of compliance with laws and regulations and consider the adequacy of management's assessment.
- Review with management its plans and progress for correcting material internal control weaknesses and non-compliances and consider the appropriateness of such plans.
- Review with auditors any observations on internal control and compliance issues, including their planned work in these areas.

DoD Audit Committee

Scope and Responsibilities

Department Performance

- Review financial and program results and trends to measure performance and identify areas of risk or concern.
- Monitor implementation of plans for improving financial management processes and systems.

DoD Audit Committee

Scope and Responsibilities

Financial Report of the Department

- Become familiar with significant accounting and reporting issues of the Department.
- Review the process for selection of the external auditors.
- Review with management the financial statements and consider whether they are complete and consistent with known information.
- Review with management other sections of the Performance and Accountability Report and consider the accuracy, consistency, and completeness of the information.
- Review with management the results of the audit, including any difficulties encountered.

DoD Audit Committee

Scope and Responsibilities

Financial Report of the Agency (continued)

- Review the results of the independent assessment of those line items or financial statements that have been asserted as audit ready by management.
- Discuss with auditors and gain an understanding of:
  - their responsibilities, audit scope and approach,
  - the results of the audit, including any difficulties encountered and other relevant matters required by generally accepted auditing standards and government auditing standards, and
  - other recommendations to improve the Department's financial management.

DoD Audit Committee

Scope and Responsibilities

Other Responsibilities

- Periodically assess and update this charter, if necessary.
- Perform other activities related to this charter as requested by the Department Head.

Communications Responsibilities

- Provide an open avenue of communication between the auditors and the Secretary of Defense, or his or her designees.
- Promptly report to the Deputy Secretary of Defense any significant issues or developments that the committee believes warrant his or her immediate attention or ensure that he or she has been made aware of such matters through internal reporting mechanisms.
- Report annually to the Deputy Secretary of Defense on committee's activities and recommendations.

Executive Steering Committee

- Members:

  Voting Members: Deputy CFO (Chair); Deputy Comptroller (Program/Budget); Director, Defense Finance and Accounting Service

  Non-Voting Members: Assistant Inspector General for Audit (advisor)

- Reporting: Reports to Under Secretary of Defense (Comptroller).
- Scope and Responsibilities: Review, approve, and prioritize those financial statement items that components assert are candidates for assessment and audit. It will also centrally help to plan and asses funding and evaluate requirements.

Appendix D

Key Points* in Draft Charter for Financial Management Advisory Group

* Draft written charter, which contains more detail, has been supplied to clients

Mission

- Name
  - Financial Management Advisory Group (FMAG)
- Mission
  - Provide advice to DoD senior leadership on audit and financial management issues
  - Help DoD communicate the importance of achieving a clean audit opinion

Specifics of Mission

- Meet periodically and receive briefings on status of financial and audit efforts
- Provide advice to senior DoD leaders on how best to improve financial management and achieve a clean audit opinion
- Recommend best ways to communicate importance of audit plan efforts

Membership

- Chairperson
  - Recognized expert in the field of audit and financial management
- Up to eight additional members
  - Each member shall have substantial experience or commitment to improving financial management and auditability
  - Members shall be chosen so that FMAG represents or has contacts with groups critical to success (including Congress, senior financial leaders outside DoD, commercial audit firms, retired senior executives, retired flag officers)

Operating Procedures

- FMAG shall meet at least three times a year in Washington, D.C. area
- Senior DoD participation
  - Efforts shall be made to permit SECDEF or Deputy to participate to some degree
  - Undersecretary (Comptroller) and Deputy Inspector General for Auditing shall participate substantially
  - Meetings shall involve senior Service FMs and their staffs

Operating Procedures (con't)

- At each meeting USD(C), with input for Deputy for Audit, shall identify issues on which advice will be sought
- FMAG chairperson will guide discussion, or assign tasks, to ensure that advice is provided
- FMAG chairperson will also seek advice from members on areas that need attention
- FMAG will generally provide advice in verbal form.
  - No written reports unless specifically requested
- FMAG has no operational responsibility
  - Not a Sarbanes-Oaxley committee
- USD(C) will provide needed funding and designate a member of comptroller staff to act as Executive Director

Structure of Financial Management Advisory Group

- Option 1: (separate Federal Advisory Committee, i.e., FACA)
- Option 2: (Task Group of Defense Business Board)
- Option 3: (Hire individuals as independent consultants)

Next Steps in Creation of FMAG

- USD(C), with Deputy for Audit, revises charter
- USD(C), with Deputy for Audit, creates list of possible names
  - DBB can assist
- USD(C) secure approval to establish FMAG
- USD(C), and Deputy for Audit, secure agreement of potential members
- SecDef charters group and issues formal invitations to members