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THE IMPORTANCE OF FOCUSING ON INTERNAL CONTROLS

Remarks as delivered by Department of Defense Acting Principal Deputy Inspector General Gene Reardon to the American Society of Military Comptrollers (ASMC), Denver, Colorado, October 27, 2005.

Thank you for that very generous introduction. I know bio's are a challenge. My boss probably wouldn't recognize me.

Recently, the world has gone through tsunamis, hurricanes, hurricanes, earthquakes, major floods, the looming threat of pandemic disease, and the Redskins first loss this season to the Denver Broncos; luckily I'm a Kansas City Chiefs fan. We also lost greats this past year like Johnny Carson and Ossie Davis, and we continue to be at war.

But right now, I'm here with you today. I'm from Washington, and I'm here to talk about opinions, internal controls, and other titillating subjects. You know, I must be an auditor if those subjects are titillating.

How many of you want to go back to discuss hurricanes?

Before I launch into the four or five technical subjects I'll speak on today, I want to tell you about a story that I read in a recent edition of the Washington Post. This story captured my emotions because it is so close to what YOU and I do for a living. We wonder sometimes how our work can really make a difference; how it affects the people within DoD. I'm not talking just about the managers, but everyone who is connected to the Department of Defense, and that is pretty much all of us.

The story dealt with a soldier who had been severely injured in Iraq. It really doesn't matter what Military Department was involved, because we should all accept blame for what he went through.

This soldier had lost his left hand and had suffered severe shrapnel wounds in Iraq. He was in for the long haul dealing with intense pain, recovery, and rehabilitation. He spent many months at Walter Reed Army Medical Center trying to imagine what he would do with the rest of his life.

Never did he imagine that he would be hit with a bill by his Military Service for \$6,200 as a result of his status change because he was now out of a war zone and because there was a question as to whether his combat gear had been properly accounted for.

This soldier is not alone. According to the article, 331 other soldiers were recently identified as having been hit with similar kinds of military debt after serving and being wounded in the war zone.

It turns out that the root of the problem is an outdated Department of Defense computer system. It's outdated because it does not automatically link pay and personnel records. This we all know creates numerous pay errors and other issues. Consequently, overpayments become debts. This not a new problem.

According to the newspaper, the Department has been working on upgrading and modernizing this particularly troubling system since the mid-1990s. The Department has yet to be successful. I believe we in DoD have actually been working on this issue much before 1990. What the paper doesn't say is that these are really difficult issues. But we still have to solve these issues.

As Auditors and Financial Managers for DoD and the Military Departments, we cannot continue to allow problems like this to happen. We cannot be lax in doing our jobs if we expect to keep our war fighters like this soldier focused on the business at hand—that of fighting for this Nation and defending America.

We must be ever vigilant about perfecting our processes and procedures so that the achievement of our goal nears perfection and that we operate always at full capacity.

Soldiers, sailors, airmen, and Marines can't afford to fight wars half-way; we can't afford to support them in their efforts half-way either.

(Opinions on Internal Controls Related to Financial Statements)

I have several things I am going to talk about today, and my first subject is on internal controls. (Groans are expected.)

Rather than treat internal controls or think about internal controls as a separate entity in any body or organization, we need to think about them as part of the fabric. If you do some research in the dictionary, you will find that internal controls are the guidance or management of a system. That system can be any kind of system; not just a financial system. Just recently, I've had to undergo a bit of skin surgery. It went well; however, the tummy tuck needs more work.

Before I was allowed to even get close to having the procedure, I had to complete a ream of paperwork for the doctor. That paperwork asked me for a whole bunch of information about myself. I had to tell the hospital about any pre-existing conditions, medications I might be taking, the fact that I understood their responsibilities as well as my own; and I even had to complete a pictorial chart indicating where on my body the surgery was to take place. You know exactly what I'm talking about if you've been through this yourself. What I went through was the hospital's system of internal controls. Safeguards to make sure that things are done correctly and consistently. We've all heard the horror stories about the wrong leg being amputated. Without internal controls, a hospital could

continue to cut off the wrong leg. Maybe not for long, but if it's YOUR leg, YOUR eye, or YOUR kidney, even one mistake is one too many.

Without internal controls, there is no system of checks and balances and no chance for the system to be able to be repetitive or consistent. In keeping with the internal controls of the hospital, financial systems that work well, as they should, also need to rely on the smaller systems of internal controls.

Now, when we talk about adequate internal controls, what exactly are we talking about? Well, here is what I think we're talking about.

First, processing obligations and disbursements in compliance with applicable laws;

Second, accounting for funds, property, and other assets so that they are safeguarded against waste, loss, unauthorized use, and misappropriation;

Third, recording revenues and expenditures applicable to agency operations properly to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets;

Fourth, assuring programs and administrative and operating functions are efficiently and effectively executed in accordance with applicable laws and management policy; and

Last, being able to provide managers with useful financial information and achieving a clean opinion.

Internal control is a major part of managing an organization and includes the plans, methods, and procedures used to meet missions, goals, and objectives.

That's a mouthful. But it is very important that we know what we're dealing with. Sometimes the devil is in the details.

Have you ever had a serious urge to have a drink of water, especially in places where it isn't readily available? Try getting a drink of water at a stadium or at a fast food restaurant. What happens? If you're lucky enough to get the water, they serve it to you in a small courtesy cup. They never give you a regular soda cup or a beer mug. Do you know why? Because they're practicing internal control. The soda cups and beer mugs are accounted for to serve soda or beer. Not a freebee like water. Multiply your thirst for water times a hundred other people's thirst for water and without the internal control, the managers would soon have no cups in which to put the soda and beer that make them their money. Nor would they have a good count on what drinks were sold and how much money should be in the till. Something as simple as accounting for the soda cups and using the small courtesy cups for water is an internal control; a very important one if you're in business to sell soda or beer.

Well, that's a basic explanation of internal controls—most of you understand—but many, many managers do not, or more correctly, don't want to understand, or might I say, care. Perhaps it's because it is not their money. But it is our Service Members on the front line who are and may be affected by us not paying attention to controls.

You know that everyday we do audits that find internal controls that aren't working or where managers have not implemented required internal control programs. Why—is it for lack of understanding or not caring or non enforcement of the current law? I think it is a little of all three.

In this regard the DoDIG is refocusing more attention on what we see as a significant issue. In addition, the DoDIG does not believe that DoD should achieve clean opinions on financial statements without achieving clean opinions on internal controls.

So what about a clean opinion and why should that opinion be accompanied by an opinion on internal controls?

Considering what you do for a living, I suspect that you know there is no requirement for OSD to render an opinion on internal controls.

Sarbanes-Oxley for the private sector, specifically in its section 404, requires an opinion on internal controls.

The OMB Circular A-123, which has been recently revised (December 2004) follows Sarbanes-Oxley up to the point of requiring an opinion. A-123 makes an opinion optional. A-123 only discusses an opinion on the Statement of Assurance over financial reporting. This is in addition to the Statement of Assurance requirements over Department operations. The Statement of Assurance for financial reporting is equivalent to the assertions required of private sector senior managers by Sarbanes-Oxley.

Despite OMB A-123, GAO in doing its Government-wide financial statement has an objective—that they will render an opinion on internal controls.

Why is that opinion on internal controls a good thing to do? Why should we in OSD want an opinion?

And why a clean opinion?

A clean opinion on internal controls says you are right to be confident about the financial statements that errors are found and fixed. You are right to be confident that the numbers represent a true accounting, a program executed with integrity, right to be confident that you have soundness in the larger entity. It says you're not doing Herculean efforts to get numbers correct. In addition, you can be assured that your managers, all managers, can rely on the data they are provided.

Working for clean opinions on internal controls means identifying risks and designing actions to manage those risks to the point where negative outcomes are non-material. The goal is to have internal controls in place to ensure that no material weaknesses exist with respect to the financial and operational health of the organization.

With that as a background, I fear we in DoD focus only on getting a clean opinion on our financial statements. I agree that's a good metric. I know that with Herculean effort we can come to good numbers. However, without good internal controls, I believe that good numbers are a hollow victory. Therefore, DoD IG is adamant that the Department should focus more on internal controls and be able to get an opinion on numbers and on the controls. I fear that OSD may be too focused on a clean opinion without good internal controls. Oh, yes, let me repeat, you can get an opinion, but will it be repeatable and will managers have the information they need? These subjects—reliable internal controls and a clean opinion should come together. That's the reason why an opinion on internal controls is a good thing.

So why have I talked this long about internal controls and clean opinions? Because obviously, OSD is not there yet. And because I believe internal controls are not given the weight they deserve. It is still not a requirement to produce a clean opinion on internal controls; and therefore, not given the due they are required if we truly want to be successful.

Before I leave the subject of opinions and internal controls, let me give you my best opinion on whether or not OSD is making progress toward a clean opinion. The answer is Yes, but it is very slow and I'm concerned that unless we fix systems and the controls, we won't be able to repeat the successes that are currently being achieved.

I'm not against clean opinions, I'd just like to see them be repeatable and be able to be achieved with opinions on internal controls. I mentioned GAO is opining on internal controls for the overall Government statement, DoD is the Big Dog in the Government statement, so one way or the other, we will have to opine, OMB A-123 requiring it or not.

Since this is a wide-ranging talk I'm giving you today, I'd like to spend a few moments on audit documentation—or why do the auditors ask for proof. Or isn't your honest face or promise enough?

Why do the auditors do what they do? Well, the audit standards require auditors to follow specific steps, which require proof of existence and value. Testimonial evidence is too shallow in depth to ascertain value. Auditors need to actually see documentary evidence that describes policies and procedures, transactions, etc., which are the normal established organization controls and data. Accepting testimonial evidence by an auditor for proof that transactions or amounts occurred would be the same thing as a real estate appraiser estimating the worth of a house and not even walking inside the house, or worse yet, not even viewing the house at all.

If you remember the savings and loan fiasco we went through back in the 1980s, you know that the crux of that downfall was property being valued sight unseen and loans being given out on property that in many cases didn't even come close to its estimated value. The auditors failed in those cases.

Also, auditors need to see the exact depth of what they are auditing so that they can produce work that any other auditor familiar with the situation can be reasonably assured of repeating.

And if electronic procedures are involved, then auditors need to take additional steps in testing those procedures. The work becomes more challenging with procedures that are intermingled with systems, but it must be done to a depth that will produce the needed results and be reviewable. But just how much testing is necessary to determine what is substantial compliance with internal controls. That in itself is becoming murky. The standards are changing often and as we first go into the test, the bar is higher, and as progress and familiarity occur and internal controls can be counted on, procedures lessen. Bottom line, auditors need visible proof or assurance.

Let's shift gears and talk about certification for financial managers. I'm sure everyone is aware that some time in the future, perhaps later this year if you are an auditor or accountant or financial manager and you'd like to get promoted to a GS-13 or above, you need to be certified.

I believe that 510s and 511s should be certified. As a matter of fact, my thinking follows the letter of the law here. I'm specifically talking about The Bob Stump National Defense Authorization Act for FY 2003.

The Act says the Secretary of Defense may prescribe professional certification and credential standards for professional accounting positions (GS-510s, 511s, and 505s) within the Department of Defense. Any such standard shall be prescribed as a Department of Defense regulation.

OSD has been working on that guidance for a while. As with other professions in the private sector, we believe that 511 Government auditors should also be certified based on testing. We have found that the quality and competency of our staff in particular is directly related to the number who have achieved professional certifications. We want to ensure a common understanding of the requirements for good financial management practices and procedures. Testing that proves that an auditor is truly qualified to examine a system or process is crucial to the quality that we need to do our jobs, both efficiently and effectively. The DoD IG has more than 700 personnel who are 511s, and we want to see each and every one of them certified.

If you will allow me to again switch subjects, I'd like to move away from financial management; however, financial managers also often do a poor job in regard to this next subject.

I want to discuss briefly contractor oversight. Or DoD's ability to oversee contract performance. The reality of the magnitude of the effort being made by OSD to employ contractors or use contracts means contractors will be even more heavily involved in our business as we move forward. For example, the Army has recently announced that they intend to convert 50 percent of their current civilian jobs to contractors. From FY 1993 through FY 2004, DoD procurement of services increased from \$61.9 billion to \$127.4 billion; an increase of 106 percent. In FY 2004, DoD spent \$230.7 billion purchasing goods and services costing more than \$25,000. Of that \$230.7 billion, \$127.4 billion (55 percent) were for services.

One of our recent audits looked at contract oversight within DoD. Of the contracts reviewed by the auditors, 15 percent had the required quality assurance surveillance plans, 60 percent had no surveillance plans, and 25 percent had inadequate surveillance plans. Also, the auditors found that contracting and program offices had performed only cursory or no invoice reviews for 50 percent of the contracts, did not adequately record past performance history for 40 percent of the contracts, and did not use performance-based contracting methods for 75 percent of the contracts. So just because a few had plans, didn't mean we were using them. Given that, just what is DoD getting for its money? Well, in these above cases perhaps, substandard performance by contractors, payment for services not received, and contracts awarded to vendors who have a history of substandard performance. Bottom line in this case, DoD is not receiving best value for contracting.

How do we fix this? In the case of this audit, we are looking to the Under Secretary of Defense for Acquisition, Technology, and Logistics to reiterate to senior contracting officials and program managers the requirement for developing and adhering to quality assurance surveillance plans for service contracts. Training and education is another piece of the puzzle that needs to be in place and working. And the training needs to emphasize the use of metrics, the review of invoice procedures, and the requirement that contracting officers clearly define roles and responsibilities of contract administration personnel in each contract. This particular audit is but one example of this problem.

DoD has to also make sure that the Contracting Officers Representatives understand that they must oversee contractors for credibility and compliance with all of DoD's requirements to assure DoD that it is getting what it is paying for.

The issue of contract oversight is much like DoD's issue with internal controls. We know what it's about, so why don't we enforce it? Non-enforcement only hurts our Service Members as they attempt to defend our Nation. We all need to be sure we enforce both contract oversight and internal controls.

So far, I've spoken about Controls, Opinions, Certifications, Booze and Sex; AH HAH!, just waking up a couple of folks! And contract admin. Let me now conclude by asking you a question.

Regardless of your career position or your age or level of maturity, let me ask you now to think about your legacy. When your fellow co-workers are handing you that last plate of cake at your retirement reception, what will you reflect on concerning your achievements for your working life? What difference will you know you've made? What will people think of your contribution? Or will they?

Let me go back to our soldier I told you about at the beginning of my talk today.

That soldier's situation is definitely not the legacy we want to leave our Service Members. We cannot treat our Service Members like this and expect them to be able to fulfill their duty to preserve our Nation. We also run the high risk of not being able to replace Service Members when they leave the military. Damaging stories like the one I told you that are aired in national newspapers and on national television do not help in the military's recruiting efforts. Who would want to work for an organization where you suffer physical loss and pain and then top it off with emotional pain because of suffocating indebtedness and harassment from collection agencies?

If we have a weak internal control in our pay system, we must fix them.

Why should soldiers suffer? Why should they have to worry about that when they have so much more to worry about? Well, they shouldn't; and neither should any of our other stakeholders. We need to make sure we are doing the right thing. Is that what you are focusing on when you think of that legacy?

If you are a supervisor, what is your legacy? You have special responsibilities to the people that work for you and to the mission your group is doing. How are you measuring up at this point in your career?

For some of us like myself who is very long in the tooth, the legacy may be already indelibly etched in stone. However, I don't believe that because every day I try to make a difference, perhaps to only one person or thing, but I try. I hope you will also.

I would like to thank you for inviting me to speak with you today, and I would especially like to thank the folks from the Denver Chapter for inviting me back. I truly enjoy being out here with you and sharing my thoughts about our profession. This is a beautiful location, I love the animals in the streets, the views, and best of all, the stars.

Let me leave you with two quotes from a couple of truly great men. The first is from James Madison in the Federalist, number 51:

“If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place, oblige it to control itself.”

And the second quote is from our Secretary of Defense, Don Rumsfeld:

The pre-9/11 Secretary Rumsfeld speech on acquisition reform admonished “We will report publicly on our progress. The old adage that you get what you inspect, not what you expect, or put differently, that what you measure improves, is true. It is powerful, and we will be measuring.”

Thank you. May I take any of your questions?