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FROM INTERNAL CONTROLS TO AUDIT READINESS

Remarks delivered by Mary Ugone, Department of Defense Deputy Inspector General for Auditing and Judy Padgett, Program Director for Quality Assurance and Policy, Department of Defense Office of Inspector General on June 2, 2006, at the American Society of Military Comptrollers 2006 Conference in San Diego, California.

Thank you and good morning. Both Judy and I appreciate the opportunity to express our views on internal controls—a key to auditability.

We are tag-teaming our presentation, and we hope that it is seamless to you as an audience.

Today I'm going to talk to you about why we need internal controls, and I'll also talk briefly about the official guidance and the concepts and philosophy that the guidance is based on.

Judy is going to talk about the (1) relationships between internal controls and change, (2) the importance of meaningful controls and (3) how those controls contribute to audit readiness for the Department.

When we were developing these briefing charts, I was challenged on my choice of the word "inevitable." "Necessary" was the word that was recommended to me because "inevitable" means something that cannot be avoided or prevented. You can avoid or circumvent internal controls if they are not properly designed and followed in daily business operations. However, controls also seem to be inevitable in that people naturally organize their work, develop procedures, and define duties around things they do repeatedly. At the heart of it, controls are fundamental to a society that wants order and is governed by laws.

From informal controls that either develop or evolve for convenience or protection, we institutionalize those controls that are "necessary"—controls that help us to operate effectively and efficiently, to report our financial information reliably, and to comply with laws and regulations.

Whether inevitable or necessary, internal controls must be a continuous part of any organization. Controls are needed at the beginning when an organization is forming and every day until it ends. Of course, the internal controls need to be continuous, but over time, they will not be the same.

Inevitable or necessary, beginning to end . . . and integral. Internal controls should be part of everything that we do. It is because internal controls are such an integral part of work and home life that we often don't recognize them. How many of you park in the same assigned place every day? How many of you get towed if you don't? How many of you verify the charges on your credit card? Get authorization from your spouse for a major purchase or vacation decision? At work, we have a long list of things we "have to do," and some of those things are, in fact, part of internal control.

This is internal control for both operations and financial reporting. I want to emphasize that the arrival of Appendix A with its specific requirements for reporting on the internal controls over financial reporting doesn't make internal controls unnecessary in operations.

I'd like to now refer you to the timeline on the screen. This timeline shows how long the basic ideas for internal control have been around in terms of legal requirements for government entities. In 1982, the FMFIA, or Federal Managers' Financial Integrity Act, established the need for internal controls to operate efficiently and effectively, to report financial information reliably, and to comply with laws and regulations. The Office of Management and Budget (OMB) and the Government Accountability Office (GAO) developed the implementing framework for the public law. Subsequent iterations developed more detail and definition for internal control standards.

The 1999 GAO (Government Accountability Office) standards were very similar to those of the Committee of Sponsoring Organizations of the Treadway Commission. This Committee is better known as COSO, which recommended a framework for internal controls primarily consisting of five standards. Judy will touch on those in her part of the presentation.

Then in 2002, Sarbanes Oxley came along, and its influence was a major factor in adding Appendix A to the revised OMB Circular A-123.

There are some key dates that aren't listed here, but they certainly play a role. The only reason you don't see them listed is that it's difficult to get everything on a slide that we can all still read. Two dates with significant laws are 1990 (the Chief Financial Officers Act) and 1996 (the Federal Financial Management Improvement Act). These laws significantly impact agencies and re-emphasize the need for effective internal controls. OMB Circular A-123 Revised, page 21, paragraph 1, states that "Federal Agencies are subject to numerous legislative and regulatory requirements that promote and support effective internal control."

The paragraph¹ goes on to describe those two laws: This is the only citation I plan to use, but since I'm an auditor I needed to cite at least one specific criteria. I promise no more.

Let me emphasize here that internal control is for everyone and that theme is recurring in this presentation. You may call internal controls by another name, but it is that which helps in ensuring order, results, and governance. The addition of the requirements for financial reporting has put an extraordinary focus on the financial arena, but it is still part of the Managers' Internal Control Program. The Managers' Internal Control Program is key to providing guidance on the annual statement of assurance and telling us how the program should look in the DoD. The Comptroller does that through the DoD Instruction 5010.40 and the annual guidance for preparing

¹ The Chief Financial Officers Act (CFO Act) of 1990 requires "agency CFOs to, 'develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls, which . . . complies with applicable . . . internal control standards . . .'"

The Federal Financial Management Improvement Act (FFMIA) of 1996 "instructs agencies to maintain an integrated financial management system that complies with Federal system requirements, Federal Accounting Standards Advisory Board (FASAB), and the U.S. Standard General Ledger (USSGL) at the transaction level."

the statement of assurance. The Comptroller is responsible for developing that guidance and for compiling the results, but that doesn't mean the Managers' Internal Control Program applies only to comptroller or financial types of organizations. DoD Instruction 5010.40 and the annual guidance clearly have requirements for operations too. Operations need internal controls or we may not have anything to reliably report financial information about.

Returning to the timeline for a moment, let me point out that A-123 appeared more than once. A-123 gets updated periodically to better fit current conditions, but the foundation remains the FMFIA (Federal Managers' Financial Integrity Act). The most recent version of A-123 changes perspective rather than those basic principles of operational effectiveness and efficiency, reliable financial reporting, and compliance with laws and regulations. The current A-123 perspective is more detailed. It is modeled after the COSO and the GAO (Government Accountability Office) standards for internal control—that is, it is built on the five standards for internal control.

In our audit function at my organization, we now find ourselves assessing internal controls in other parts of the world and in a combat environment. But the controls we encounter in our audit work should not be a surprise. These controls should not be any different from what we see every day in our work here. What is the bottom line objective when we use a fund, a resource, and an asset? The objective will continue to be the accomplishment of the mission.

Let me give you an example. The funds used to support U.S. efforts in Iraq and Afghanistan may be in the form of cash. It may not be the norm for Government operations stateside, but in countries particularly where there is either no banking infrastructure or a disrupted infrastructure, cash is used. Does cash require a different perspective and set of accounting controls in countries where there is no underlying information technology infrastructure? Yes, because the control environment is at higher risk, which warrants emphasis on fundamental controls based on physical safeguards as well as the written record, reconciliation, and verification. Remember, there are no banks to help record, reconcile, and verify. At the same time, remember, these funds are being used to accomplish a mission objective. Using this scenario, for example, we ask ourselves the question: Have the Iraqi security forces received the required training obtained by the funds? That is the mission objective, so yes, they should have received the required training using those funds. This is why comptrollers (you in the audience) are so important to the internal control process. Regardless of form, any payments that link the financial to the mission objective must be transferred under a system of controls so that it ends up where it should and satisfies the achievement of the mission at hand.

A-123 also has detailed requirements for areas of high interest from our lawmakers: financial reporting (Appendix A), government charge card program (Appendix B), and proposed improper payment guidance (proposed Appendix C). That last appendix title—last appendix title—seems to have been written by a poet where repetition of a consonant is often used in a poem. However, let me assure you, A-123 is definitely not poetry. Please note that the internal control requirements are not new—the additional focus is new. Reporting on the internal controls over financial reporting is what is new—what is a change in perspective. That certainly reflects the influence of the Sarbanes Oxley Act.

The theme of this conference is waves of change. Most certainly the changes we are experiencing thanks to Sarbanes Oxley and A-123 Appendix A and our efforts to get to audit-ready financial statements can make it feel like we're caught in a nasty undertow. I suggest we regard those waves of change with the solid foundations of the underlying internal control concepts in mind.

I keep returning to this point—internal controls are not new ideas. Internal controls such as separation of duties, reconciliations, authorizations, standard operating procedures, and more have been around since long before the FMFIA (Federal Managers' Financial Integrity Act) or Sarbanes Oxley or Appendix A. The very foundation of this nation is based on a system of checks and balances—one of the most visible systems of internal control. Oftentimes we need to recognize what is already there. We don't need to invent something new with every new program—we just need a different perspective and perhaps emphasis, or even a re-emphasis. We need to continue reminding ourselves that internal control is for everyone and is part of everyday government function.

As financial personnel, you experience controls both at the operational and financial level. This experience can work for you and your organization. Tap into it in order to identify the internal controls we have but have not recognized. During that process, determine which controls require change and which areas require controls because there are none. Look at the controls from someone else's perspective. The process of identification and implementation is one that is already built into the standards for internal control and a process that Judy is now going to talk about.

Three of the five standards (environment, risk, control activities, information/communication, monitoring) are shown here but if you examine and think about the standards, all five are designed to accommodate change and continuous consideration. Risk is at the top of the list because it is one of the areas where major factors such as economics, politics and natural phenomena, are often out of our control. All five standards are intertwined. For example, a change in risk should result in a change in the activities to eliminate or minimize the risk and its effects. A change in the activities must be communicated to the organizational community—this could mean employees, customers, vendors or all of the above. Once a control activity is implemented, we need to monitor it to determine whether it actually achieves the control objective to minimize the effects of the risks identified, whether the control was effectively communicated—people are using the control, is it effective as designed . . . the monitoring has to occur over time so adjustments can be made as conditions and risks change. Soon we'll have a new administration and that could bring new ways of doing things. Yesterday marked the beginning of what's expected to be a very wicked hurricane season. Will that change our controls? So—change is very much a part of internal control.

Here we are back at internal control is for everyone. The additional reporting requirements have created an added challenge for DoD. The overall reporting will include the material control weaknesses identified for both pieces of the statement of assurance, that is the operational and the financial reporting, to maintain visibility over the weaknesses. The financial reporting corrective actions are included in the FIAR plan and recognized by the Defense Business Modernization Program.

I'm pointing out once again that although the focus has changed from OMB with the requirement for the financial reporting statement of assurance. The requirements for internal controls and a statement of assurance date back at least to 1982. Requirements have not changed—they've just had a makeover.

Dual reporting was levied on the DoD and other departments. The approach each Department has taken is different as I learned at a May 11th conference at which several departments had representatives speak. What DoD is doing is setting specific requirements in the DoD Comptroller's annual guidance for evaluating the status of controls and submitting the two reports. A repeated theme in the annual guidance is that this is one program. The emphasis on implementing Appendix A is pervasive in the Federal community and the contractors who serve them and it will take work to keep operational leaders and managers engaged on this. We can't have this be "Just a financial or just a comptroller exercise"—and there is no "just" about the financial piece of this. My concern, it seems, is that to keep operations engaged, the financial piece gets minimized and that can't happen either. We have two important pieces to this Managers' Internal Control Program. I want to say a bit more about the two pieces of the Managers' Internal Control Program and the annual guidance that applies to the annual reporting.

Part I of the guidance, the directions for the Statement of Assurance on the effectiveness of IC for programs, administrative activities and operations, is reasonably well developed. The dates and products are known, the evaluation and compilation procedures have been developed and followed for several years, the program managers for Managers' Internal Control have experience with the process. Because Part I has been around for a while, the methodology and reporting are stable, slower to change, less radical changes.

Not so for financial reporting. Financial reporting is not familiar. No change is quite so radical as the first time meeting a requirement. Part II of the annual guidance has several key dates, most of them are already passed. In December, those who are subject to Part II guidance delivered process narratives, flow charts, and organizational charts for the focus areas, in February they delivered risk analysis and in March internal control lists and test plan methodology. Most recently, the Part IIers delivered internal control review reports and corrective action plans. The documents and assessments from the Part II deliverables form the framework for producing the Statement of Assurance on financial reporting. As experience is gained and the focus list expands, those in financial reporting will probably experience considerable change in the assessment and reporting process as lessons are learned and until the financial reporting Part II guidance stabilizes. Once the guidance stabilizes, financial reporting entities will likely experience slower and smaller changes in the procedures to prepare the Statement of Assurance. As for the specific controls and the Managers' Internal Control program, financial reporting entities may experience less change than their operational counterparts because accounting procedure and reporting tend to vary less over time than do operations and programs.

Notice that I didn't say change would stop for either operations or financial reporting. Although the pace and focus may differ for operations and financial reporting, it is important for a well-built program that both pieces be flexible, adaptable—dynamic for an effective Managers' Internal Control Program.

We spoke earlier about recognizing what the Department already has and building on that. The goals and objectives of our systems of controls should be consistent with other programs and initiatives that are underway. The Comptroller has fit the financial reporting Statement of Assurance and the deliverables leading up to it into the Financial Improvement and Audit Readiness plan. In the transmittal of the plan the honorable Gordon England stated:

The Financial Improvement and Audit Readiness Plan, spearheaded by the Under Secretary of Defense (Comptroller), is the DoD roadmap to fix internal controls, correct processes, and obtain an unqualified audit opinion. The plan integrates solutions such as upgraded systems with improvements to processes.

The Financial Improvement and Audit Readiness Plan (FIAR) is about understanding what we have and building on that and so is the Managers' Internal Control Program with its assessments and documentation and statement of assurance for financial reporting. The assessments are about identifying the existing controls and about discovering where the controls need change, communication, commitment or creation. In this process we must—to the very best of our ability—be accountable to and protect both the taxpayer and the warfighter. This can be a challenging balancing act, one that Mr. England referred to in his message in the 2005 Performance and Accountability Report. His message ended with this: “The Department of Defense continues to transform itself into a more agile organization able to meet the challenges of the 21st century. The Department must continue to improve its financial accountability, shift resources from the bureaucracy to the warfighter, and improve the quality of life in our armed forces—and is committed to do so.”

What Mr. England's message says to me is that we **must** use what we have rather than build yet another piece of bureaucracy. We don't want implementation of Statement of Assurance on financial reporting to take away badly needed resources from our armed forces. We need everyone's involvement and we need to integrate and leverage plans in place. In addition to the FIAR plan, there are other improvement plans and even informal procedures that we can use to arrive at the audit ready financial organization that is the Department of Defense.

The documents delivered over the past few months have recorded the controls already there. The opportunity to document “what is” might not be over--because this was the first year, we may need add to and embellish the deliverables next year.

In addition to offering an opportunity to analyze and document procedures, the Statement of Assurance on financial reporting is an opportunity to put results and progress on the FIAR and financial reporting improvements in the public view via the PAR.

The analysis opportunity may also show that there among the “what is already there” is some “not there yet” that needs to be identified, designed, and implemented.

Those controls that “are not there yet,” the ones that need to be identified, designed, and implemented should have these features—

- Meaningful. If you are wondering what a Potemkin Village is, well so was I when I heard it a few weeks back. Potemkin was a Russian Minister who, according to popular mythology, built empty structures to impress Catherine the Great and thus improve his standing because of the valuable assets added to her domain. We don't want to build empty structures to impress the auditors or other reviewers.
- Practical and simple—increases the likelihood of implementation and success.
- Cost beneficial—this is one of the underlying principles of controls. The taxpayer doesn't want to pay for perfection. We can't afford perfection.
- Effective—now I have the word effective here twice but it probably needs that kind of emphasis. Not only must we avoid empty controls, those just for show, but we must monitor controls to make sure they work, that all the people affected by them understand them and are getting the intended benefits.

Effective internal controls have a cascading effect. Once again, it is difficult to figure out what comes first—the controls or the environment but as we work to get all standards together audit readiness becomes possible. That was conveyed in both messages I quoted from Mr. England.

The cascading effect might look something like this. Of course, this is a simplistic presentation and it doesn't include internal controls over processes or over safeguarding assets—the other two internal control objectives. I hope that what you see here is a progression—one that might even get easier as we gain experience and as internal controls improve.

We'll take questions now.