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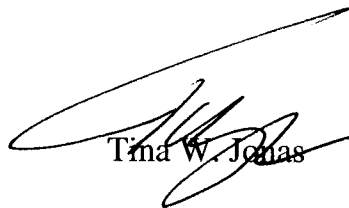
SUBJECT: Update on Financial Improvement and Audit Readiness Activities

In a memorandum on the Department of Defense audit strategy dated April 25, 2007, I described the need for a revised audit strategy that would allow the Department to sustain financial management improvements while meeting audit standards. After working with the Government Accountability Office, the Office of Management and Budget, and internal and external audit communities, I made the decision to delay the submission of the Financial Improvement and Audit Readiness (FIAR) Plan.

This week, I forwarded an update on activities related to the FIAR Plan to the U.S. Congress and the Office of Management and Budget. The attached FIAR update details accomplishments achieved during the period October 1, 2006, through June 30, 2007; introduces the Department's revised audit strategy; and, for the first time, highlights the achievements and challenges facing select defense organizations. The Department continues to make significant progress in improving its financial management, and the projected revisions to the audit strategy set a course for maintaining audit readiness.

The next full release of the FIAR Plan will include additional information on the audit strategy and additional insights into the comprehensive financial improvement efforts of the DoD.

Thank you for your support of our financial management improvement efforts. I look forward to working with you as we continually strive to improve the process and sustain success.



Tina W. Jonas

Attachment:  
As stated

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# Overview

The Defense Financial Improvement and Audit Readiness (FIAR) Plan is the Department's roadmap for improving the overall financial management health of the Department of Defense. Submitted to Congress and the Office of Management and Budget twice yearly, the FIAR Plan details the progress achieved to date in several important areas.

Improvement efforts proceed along two tracks: 1) those that improve the accuracy, timeliness, and availability of financial information; and 2) those that help the Department achieve audit readiness.

Since the plan was initiated in December 2005, clear progress has been made toward the goal of achieving audit readiness. Today, seven Defense reporting entities have received an unqualified audit opinion. They are the:

- Defense Commissary Agency,
- Defense Contract Audit Agency,
- Defense Finance and Accounting Service,
- Defense Threat Reduction Agency,
- Military Retirement Fund,
- Office of the Inspector General, and
- Chemical Biological Defense Program.

In addition, the Medicare-Eligible Retiree Health Care Fund has received a qualified opinion; three DoD-wide financial statement line items have received favorable audit reviews; and the Department of the Navy is ready to validate the audit readiness of its \$12.7 billion Environmental Liability, for nuclear and conventional ships, which represents 18 percent of the Department's total Environmental Liabilities.

Based on discussions with the internal and external audit communities, the Department's original audit strategy has been refined from one that conducts *full-scope audits* of line items to one that ensures that a line item is *audit ready* as confirmed by an independent validation. Readiness will be sustained through a process of annual assessments and internal controls.

The June 2007 update on the Financial Improvement and Audit Readiness (FIAR) Plan is the fourth submission to Congress. It includes accomplishments achieved during the period of October 1, 2006, through June 30, 2007; details the new audit strategy and current DoD business environment; and describes the financial management challenges faced by the other Defense organizations, including the U.S. Special Operations Command, Defense Advanced Research Projects Agency, Defense Information Systems Agency, Missile Defense Agency, and Defense Security Service.

# Accomplishments

Financial management improvement efforts under the FIAR Plan proceed along two tracks: those that seek to improve the Department’s financial information (such as streamlining procedures, improving the timeliness and availability of financial information, or capturing more relevant information), and those that help the Components achieve audit readiness (such as testing internal controls).

Since the FIAR Plan was first submitted in December 2005, clear progress has been achieved in several important areas. The most significant accomplishments achieved during the October 1, 2006, through June 30, 2007, period of performance are highlighted below:

<b>ACCOMPLISHMENTS OCTOBER 2006 THROUGH JUNE 2007</b>	
✓	Navy’s Nuclear and Conventional Ships Environmental Liability (\$12.7 billion), is undergoing an examination to determine its audit readiness.
✓	Defense Logistics Agency (DLA) migrated the National Stock Numbers (NSN)/items and users from a legacy system to the Enterprise Business System. A NSN ties logistic information to an item of supply. The new system supports the management of 5.2 million NSN/items, 7,019 users, and \$17.7 billion in annual demand.
✓	Acquisition Technology & Logistics (AT&L) confirmed that military equipment baseline valuations are correct, that all military equipment that should be capitalized has been valued, and that DoD owns and has the rights to all capitalized military equipment.
✓	Accountability Improvement Plans that detail steps required for assertion of Military Equipment have been developed by the Army, Navy and Air Force.
✓	Sustainable business processes and management controls to improve the accuracy of Construction-In-Progress cost information have been established by AT&L.
✓	Unique site identifiers have been assigned to all DoD-owned Real Property sites and the process for updating and maintaining the identifiers has been automated. Unique site identifiers eliminate ambiguity and ensure consistent reporting of Real Property sites.
✓	The policy for the management, inventory, and accountability of personal property has been revised and improved by AT&L.

**ACCOMPLISHMENTS  
OCTOBER 2006 THROUGH JUNE 2007**

✓	The functional requirements for the Defense Property Accountability System that will lead to Standard Financial Information Structure compliance and successful interface with other business modernization initiatives, such as Wide Area Workflow and Unique Identifier (UID), have been completed by AT&L.
✓	A passive Radio Frequency Identification infrastructure at 18 CONUS and 2 OCONUS Distribution Centers has been installed by DLA. The infrastructure will enable more accurate and detailed data about tagged items.
✓	Navy asserted that Cash and Other Monetary Assets (\$172 million) is ready for independent validation to confirm audit readiness.
✓	Key business process flowcharts, risk assessments, and control test plans, as required by OMB Circular A-123, Appendix A, have been submitted by Components that prepare stand-alone financial statements.
✓	Metrics to monitor timely processing of purchased care claims and computation of claims liability have been developed by Medicare Eligible Retiree Health Care Fund (MERHCF).
✓	Documentation of Navy medical facilities' monthly financial reconciliation processes, and verified audit trails for medical facility expenses, have been completed by TRICARE Management Activity (TMA).
✓	The Defense Property Accounting System has been successfully tested by TMA.
✓	Reconciliation of purchased care claims has been performed, and the claims processing backlog has been reported and resolved by TMA.
✓	Defense Finance and Accounting Service (DFAS) accomplished year-end changes to military pay systems resulting in continued timely and accurate pay and tax statements.
✓	Pay accounts for soldiers evacuated from a theater of operations for medical inpatient treatment between May 1, 2005, and April 30, 2006, in compliance with the National Defense Authorization Act 2007, have been audited by DFAS. A report was submitted to Congress by the Army on February 14, 2007.
✓	Air Force asserted that the Working Capital Fund Fund Balance with Treasury is ready for independent validation to confirm audit readiness.

Audit readiness of the DoD Consolidated Financial Statements will not be achieved until the Department has successfully deployed a number of new finance and business systems. However, significant progress has been made by several Defense reporting entities as a result of sustained improvements to processes, the establishment of effective internal controls, and increased training.

As indicated below, seven Defense reporting entities have received an unqualified audit opinion and, for the third consecutive year, the Department has received favorable audit reviews on three significant financial statement items.

<b>DoD REPORTING ENTITY</b>	<b>AUDIT OPINION</b>
Defense Commissary Agency	Unqualified
Defense Contract Audit Agency	Unqualified
Defense Finance and Accounting Service	Unqualified
Defense Threat Reduction Agency	Unqualified
Military Retirement Fund	Unqualified
Office of the Inspector General	Unqualified
Chemical Biological Defense Program	Unqualified
Medicare-Eligible Retiree Health Care Fund	Qualified

<b>DoD-WIDE FINANCIAL STATEMENT LINE ITEMS</b>	<b>AUDIT REVIEWS</b>
Investments	Favorable
Federal Employees' Compensation Act Liabilities	Favorable
Appropriations Received	Favorable

## The Revised DoD Audit Readiness Strategy

The audit strategy presented in earlier versions of the FIAR Plan focused on incremental financial improvements measured by independent audits of financial statement lines that verified management's assertion of audit readiness. The lines were organized into focus and non-focus areas based on their material impact on:

- The Department's consolidated financial statements, and
- Individual stand-alone auditable financial statement presentations.

While the Department continues to focus on incremental financial improvements to achieve audit readiness, several refinements, and the timing of those refinements, have been introduced in response to internal and external audit community recommendations. Based on those

recommendations, the Department has broadened its focus to include the Enterprise-wide financial environment in addition to the current financial statement lines by Military Services and Components.

The increased focus on the Department's Enterprise-wide financial environment includes business processes and system interdependencies. The refinements also include greater flexibility in the application of the Department's business rules, as well as more options within each business rule. The revisions to the Department's business rules are particularly applicable to the independent verification of management's incremental assertions to verify audit readiness.

The Department continues to refine its audit readiness strategy to more effectively align available resources with its financial improvement and audit readiness initiatives. The improved financial environment will promote the Department's compliance with the Chief Financial Officers Act of 1990, improve management's decision making capability, and strengthen its credibility with the taxpayers and Congress.

The desired outcomes of the audit readiness strategy are as follows:

- Sustainable incremental financial improvements to support an unqualified audit opinion of Department's consolidated financial statements,
- Sufficient audit readiness to receive an unqualified audit opinion for each of the Military Departments and select Defense Agencies, and
- Assurance that financial recording and reporting by Defense Field Activities that are not required to prepare auditable financial statements are not constrained by any material weaknesses that would impair the timely, fair, and accurate presentation of financial statements.

## **FINANCIAL ENVIRONMENT**

The Department's financial management is considered high risk by the Government Accountability Office (GAO). Areas identified by GAO as critical financial functions in need of improvement include the ability to manage costs, maintain accountability, anticipate future costs, and control funds.

The Department is working closely with the GAO, the Office of Management and Budget (OMB), and the Office of the Inspector General, Department of Defense (OIG) to achieve audit readiness.

The Department's financial recording and reporting environment is complex and interrelated. Individual segments (material components that remain constant from year to year) apply both vertically, by Component, and horizontally across the entire Department. Examples of segments include:

- Business process (Civilian Pay)
- Financial statement line (Cash and Other Monetary Assets)
- Group of related financial statement lines (Fund Balance with Treasury, Accounts Payable, and Accounts Receivable)
- Sub-line (Military Equipment)

In this context, the three critical elements of the refined audit readiness strategy are:

- Recognition of the Enterprise-wide, or horizontal, elements of the financial environment in the selection and timing of individual financial improvement and audit readiness initiatives;
- Identification of audit readiness segments for the Military Services and Components as well as across the Department, and
- Revision of the Department's business rules to sustain incremental financial improvements while limiting audit engagements to full financial statements.

The vertical and horizontal segments of the financial environment apply equally to individual lines, sub-lines, groups of lines, and full financial statement presentations, and apply as well to the Military Services and Components. The objective of the segmented, or incremental, approach to audit readiness is to reasonably manage the size and complexity of the Department's financial environment while ultimately achieving audit readiness on the full financial statement presentation. These segments include:

- End-to-end business processes;
- Core, feeder, and mixed systems;
- Internal control policies, procedures, and environment; and
- Applicable laws and regulations.

Achieving and maintaining these incremental financial improvements will eventually support an unqualified audit opinion on the Department's consolidated financial statements.

## **Revised Business Rules**

The migration from an audit strategy to an audit readiness strategy is reflected throughout the Department's refined business rules. There are two primary refinements to the business rules:

1. An increased focus on sustaining and maintaining independently validated incremental gains, rather than pursuing annual audits of those incremental gains. Audit engagements will be undertaken only after the total financial statement has been independently validated as audit ready; and
2. An expansion of the "segments," or elements, of the financial environment that define the basis for incremental improvements.

Given the greater emphasis on sustaining incremental gains, the options for validation of those gains are also expanded. For example, professional standards, which include attestation engagements will be used to independently verify and sustain audit readiness at reduced cost. In addition, in the Discovery and Correction phase and the Sustainment phase, the revised audit readiness strategy will leverage existing OMB A-123, Appendix A annual compliance procedures to ensure continued audit readiness.

Attestation standards offer greater flexibility at reduced cost by tailoring the scope of work needed to satisfy the audit readiness validation and sustainment phases of the revised business rules.



An attestation engagement will be used to 1) independently validate management's assertion of segment audit readiness (audit readiness validation phase) and 2) verify sustainment of previously validated segments' audit readiness (audit readiness sustainment phase).

Attestation standards include the following types of engagements:

- Examination – includes a report and opinion on the reliability of management's assertion of audit readiness. Benefits, particularly as a precursor to financial statement audit, include a high level of assurance with a corresponding low level of risk. The examination report on management's assertion will opine on the accuracy, reliability and timeliness of the financial information, and the related financial statement presentation, through the evaluation of applicable end-to-end business processes, financial core, feeder and mixed systems, internal control policies, procedures and environment; and compliance with laws and regulations.
- Review – while providing a moderate level of assurance and a commensurate moderate level of risk, using a review engagement for internal controls over financial reporting or compliance with laws and regulations, is not allowed.
- Agreed Upon Procedures (AUP) – Unlike an examination, an AUP shifts the responsibility for the scope of work to management as opposed to an independent third party. While a report of findings is issued, the report is limited to specific procedures. Unlike an examination, no opinion is included. Given the relatively narrow focus of an AUP, and the fact that responsibility for the scope of work rests with management, an AUP is not the preferred attestation engagement to validate management's assertion of audit readiness. However, once the segment has been validated as audit ready, the conditions necessary to annually sustain the segment's audit readiness can be sufficiently identified for a more focused scope of work. An AUP is viable for the audit readiness sustainment phase under those conditions.

The revisions to the business rules do not require continuation of an independent assessment and audit engagement on an incremental basis as prescribed in the original business rules. Instead, incremental gains, once independently validated, would require only those actions necessary to sustain those incremental gains until the financial statement in total is verified as audit ready.

The independent validation phase will verify management's incremental assertion of audit readiness more efficiently and with less cost. The level of assurance and associated risk will determine the scope of the engagement needed to sustain incremental gains as we move towards complete audit readiness.

Incorporated within each business phase is compliance with OMB Circular A-123, "Management's Responsibility for Internal Control," Appendix A, "Internal Control Over Financial Reporting." A-123 Appendix A defines the requirements and details of management's assessment of internal controls related to financial reporting.

The revised business rules outlined below continue the process for examining operations, diagnosing problems, planning corrective actions, and achieving audit readiness. These business

rules are applied uniformly across the Military Services and Components. They incorporate the shift to sustainment of incremental improvements. As we execute the audit readiness strategy each Component will move through the following phases:

1. **Discovery and Correction:** Management evaluates individual financial segments, identifies weaknesses and deficiencies, and implements corrective actions.
2. **Segment Assertion:** Management asserts audit readiness to the OIG and the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) for concurrence using the 18 tab assertion package guidance.
3. **Audit Readiness Validation:** OIG or Independent Public Accounting (IPA) firm validates management's assertion using an examination engagement.
4. **Audit Readiness Sustainment:** Management will use OMB A-123 Appendix A, as guidance to annually verify segment audit readiness.
5. **Financial Statement Assertion:** Management asserts audit readiness to OIG and OUSD(C) for concurrence
6. **Financial Statement Audit:** OIG or IPA performs audit of the organization's financial statements.

Detail explanations of the refined business rules follow:

**Discovery and Correction Phase.** The Discovery and Correction phase remains the foundation for all subsequent business rules. Its purpose is to evaluate the current financial environment and identify weaknesses and deficiencies that would prevent the entity from obtaining an unqualified audit opinion. Steps taken during the discovery and correction phase remain essentially the same in the refined business rules. The Military Services and Components will:

- Identify deficiencies by segment.
- Prioritize deficiencies that have a material impact on the financial statement presentation.
- Prepare corrective action plans to resolve the weaknesses and deficiencies. Corrective actions will include measurable remediation steps and completion dates to ensure that each item identified in the Financial Improvement Plan (FIP) is addressed and resolved. All corrective actions are not expected to be completed at the same time. Corrective action plans will include any requirement for systems evaluations in anticipation of the eventual validation of segment audit readiness.
- Closely align corrective actions with OMB, Circular A-123, Appendix A. Appendix A requires management to review its procedures, flowchart its processes, evaluate material risks, and identify and test internal controls for annual assessments of internal controls over financial reporting.

During this phase, the Military Services and Components will prepare a FIP that further delineates clear and measurable steps under each business phase for achieving complete audit readiness. FIPs are currently prepared in accordance with the appropriate OUSD(C) memorandum dated August 8, 2003, or September 18, 2003.

**Segment Assertion Phase.** The Segment Assertion phase represents the culmination of management’s internal efforts to evaluate its financial environment. Management asserts that corrective actions have been successfully implemented and the segment is ready for audit. The segment assertion phase focuses on management’s assertion that the financial information gathered from the financial environment is timely, reliable, accurate and fairly presented.

The purpose of the segment assertion phase is to notify the OIG and the OUSD(C) that management asserts the segment is ready for validation of audit readiness.

- Management will submit its assertion letter, prepared in accordance with OIG memorandum “Management Assertions,” asserting audit readiness.
- The Entity will prepare an assertion package of accompanying documentation to support its assertion of audit readiness.
- The Entity will submit the assertion package to the OIG, with copy to the OUSD(C).
- The OIG and OUSD(C) will review management’s assertion package.
- The OIG and OUSD(C) will either concur or reject management’s assertion of segment audit readiness.

**Audit Readiness Validation Phase.** The Audit Readiness Validation phase is initiated by management and intended to affirm improvements to its financial environment by segment. The purpose is to independently verify management’s assertion that it has corrected previously identified deficiencies and that the segment is audit ready. The independent validation will be conducted by either the OIG or by an IPA. The IPA would be competitively selected.

This phase validates the thoroughness of the discovery and correction phase and independently verifies the remediation of material deficiencies. Results of the validation will determine that either:

- The segment moves to the sustainment phase with a favorable opinion, or
- Based on remaining material weaknesses, the segment returns to the discovery and correction phase.

While independent segment validation by entity remains at management’s discretion, the timing of independent validations across the Department will require additional evaluation based on enterprise-wide dependencies. Independent validations will require further prioritization based on:

- Interdependencies among audit readiness segments;
- Systems dependencies; and
- Optimum use of limited resources.

**Audit Readiness Sustainment Phase.** The purpose of the Audit Readiness Sustainment phase is to maintain audit readiness of the validated segments as the discovery and correction phase is completed for remaining segments of the financial environment. Sustainment will be achieved by an annual evaluation using OMB A-123 Appendix A as guidance. The scope of testing will be commensurate with a high degree of assurance and a corresponding low level of risk.

- The sustainment evaluation will be performed by the OIG, an IPA, a Service Audit Agency, external consulting firm, or management.

- The scope of procedures performed, and the evaluator selected, will be based on complexity, risk and materiality of the segment.
- Sustainment will include annual review of documentation, evaluation, and testing to assure continued audit readiness.

Progress will be reviewed and monitored by management and the entity's audit committee through regularly scheduled interim progress reports. Management will inform its OUSD(C) point of contact of material changes to the segment's system dependencies or any newly identified deficiencies.

Under the revised business rules, and the increased emphasis on sustaining incremental gains, management's responsibilities and the associated risks will gain greater focus. Once the validation of management's assertion has been successfully completed, and the results received, management's responsibility will be to:

- Continue the application of financial policies, procedures and internal controls that supports management's initial assertions and
- Maintain the momentum gained leading to the successful attainment of tangible financial improvements verified through the receipt of a positive validation report.

Failing to maintain the financial improvements that have been realized represents a material risk to the attainment of an annual unqualified audit opinion. Issues associated with the audit readiness sustainment phase include the balance of risk and assurance to protect against waste, fraud and abuse; the relative cost of sustainment; and the frequency of evaluation.

**Financial Statement Assertion Phase.** The purpose of the Financial Statement Assertion phase is to notify the OIG and the OUSD(C) that validation of corrected deficiencies and audit readiness has been completed for all financial segments, and that management asserts financial statement(s) audit readiness. Management will prepare an assertion memorandum and provide a revised assertion package of supporting internal and external documentation. Management will submit the complete assertion package to OIG with copy to the OUSD(C).

The assertion package will contain:

- Management's assertion letter asserting financial statement(s) audit readiness;
- An abbreviated assertion package verifying that an evaluation was performed to assure previously validated segments remain audit ready;
- Management's statement of assurance that positive periodic verifications of the audit readiness of segments under the sustainment phase have been maintained and are audit ready; and
- An independent validation opinion that the final segment is audit ready.

The OIG and OUSD(C) will review the assertion package and notify management whether it should proceed to the financial statement audit phase.

**Financial Statement Audit Phase.** The financial statement audit phase is the culmination of management's financial improvement and audit readiness efforts. Following the acceptance and confirmation of management's assertion of audit readiness, the OIG will initiate an audit engagement.

The purpose of the financial statement audit phase is to obtain an independent auditor's opinion of the fairness of the financial statement presentation. When a financial statement is asserted as ready for audit, the OIG will select the appropriate scope of work for financial statement audit and the associated reports. The OIG will make the final determination as to whether the audit engagement will be performed by the OIG or an IPA.

## **INFORMATION TECHNOLOGY (IT) ENVIRONMENT**

The Department's IT systems environment offers unique challenges for the attainment of audit readiness. Department systems range from highly efficient financially based systems incorporating state-of-the-art internal control policies, procedures and environments to relatively old legacy systems that were not designed to manage financial data and transactions.

In addition to the substantial differences in systems capabilities, the audit readiness strategy must also contend with the continual upgrade, revision, and replacement of financial systems that perform multiple functions in stand-alone and multi-user environments. The type of, and timeline for, corrective actions taken related to the systems environment is a material issue to be resolved as the audit readiness strategy is further developed.

The reliance on the system documentation gathered during the discovery and correction phase continues through the sustainment and audit phases. The sustainment and audit phases will not be successfully completed without the substantive documentation supporting the internal control and systems environment collected during the discovery and correction phase. This documentation includes system interdependencies provided by multi-user service providers.

The substantive issues relating to the Department's IT systems environment include: the reliability, and related internal control policies and procedures, of the system to process user data timely and accurately; and the coordination of information and documentation among multiple users and owners of a given system.

Audit readiness in a multi-user environment requires coordination between the system owner and the users of that system. Thus, sustaining financial improvements in the constantly evolving systems environment presents special challenges. Risk management and prioritizing financial improvement initiatives further rely on the mapping of system owners to users throughout the Department.

To be efficient, the multi-user system environment will require each owner to provide sufficient detail and documentation to users of those systems. This is an integral component of any revisions to the business rules, particularly those pertaining to the discovery and correction phases leading to the validation of incremental gains.

The system interdependencies can be related to either a single service provider or multiple service providers. An entity's typical external service provider system interdependencies are as follows:

- A multi-user external core system service provider,
- A multi-user external feeder system service provider that integrates with an entity's in-house core system, and
- A multi-user external core system service provider that integrates with either single or multiple feeder systems.

In each case, the management will rely on the multi-user service provider for sufficient documentation to support the entity's documentation of its financial environment. The documentation will be sufficient to support, at a minimum, the system interdependencies including flow chart(s) and the amount and number of transactions transmitted from a feeder system to the entity's core system.

The multi-user systems can, in turn, be either core systems, feeder or mixed systems. The core system will be the primary system serving the user's financial environment. The feeder and mixed systems will be systems external to the entity's core system(s) and provide initial transaction data to the entity's core system(s). The core system can also be external to the entity. Both the entity's core system(s) and external feeder and mixed systems must be thoroughly documented including flow charting of system interdependencies.

While the attainment of audit readiness for stand-alone financial systems is relatively straight forward, audit readiness in a multi-user environment requires substantial coordination between the system owner and the users of that system. To be efficient, the multi-user system environment requires that the owner provide sufficient detail and documentation to satisfy professional standards applicable to a full financial statement audit engagement. Additionally, the owner should provide sufficient detail to satisfy management's requirement to assert its audit readiness. Both management's assertion and the financial statement audit engagement system's documentation requirements could be met through successful SAS 70 audit engagement(s).

The timing of the SAS 70 audit engagement is critical to the users that will rely on the audit report during their individual financial statement audit engagements. An overall timeline for common users should be thoroughly evaluated prior to the commitment of resources. This evaluation will support the optimum use of audit resources and minimize cost and duplication of audit engagements.

The multi-user system environment is further complicated when the multi-user system is one of many systems controlled by the same owner. Under these circumstances, the owner will be required to provide standard documentation, including policies, procedures and transaction flow charts, in support of financial statement audit engagements performed on the owner's customers for each system. Whether or not the system under review is a multi-user system, the owner should provide ready access to such substantive documentation as necessary to satisfy both system and financial statement audit engagements.

There are several advantages to providing systems documentation through the system owner rather than by each user at the time of either an attestation or audit engagement. The system's owner provides timely and consistent documentation without recreating that same documentation for each attestation and audit engagement. Consistent documentation further provides a stable basis for independent findings and observations thereby substantially reducing both the cost of the engagement and the control and detection risks. The reduction of risk will, in turn, reduce the level of substantive procedures needed, and the resultant cost, by the OIG or IPA.

An important component of the system's owner centralized documentation data base is the results of SAS 70 audit engagements. To be useful and effective, the SAS 70 audit engagement's field work and report date should be within the same year of the financial statement audit engagement. The timing of system audit engagements should be predicated on the timing of financial statement audit engagements.

A SAS 70 system audit engagement should be scheduled to serve the maximum number of user segment validation or financial statement audit engagements. Such scheduling would take advantage of the economies and efficiencies of scale that will be realized through the use of, and reliance on, a common documentation data base.

## **DEPARTMENT AUDIT COMMITTEE FORMATION**

The diversity and importance of the Department's multi-tiered financial environment, and its relationship to the audit readiness strategy's evolution, was highlighted in the September 2006 FIAR Plan. As the relationships between the system environment, financial presentation materiality and the attainment of audit readiness are further developed, the need for a Department-level audit committee was also identified.

A Department-level audit committee will bring together the talent and expertise needed to guide, and critically oversee, the continual development of the Department's audit strategy. The Audit Committee will further strengthen increased awareness across the Department to support the expansion of available options to achieve audit readiness. Additionally, the audit committee will support the increasing coordination between the ETP and the FIAR Plan.

In addition to the review of the Department's overall audit readiness strategy, the audit committee will be called upon to monitor and oversee audit engagements throughout the Department. The Department is currently refining and segmenting its audit readiness strategy to incorporate financial improvement solutions that apply across the Department as well as those initiatives that focus on a given segment. The Department audit committee is expected to facilitate and support these initiatives.

## **AUDIT READINESS STRATEGY SUMMARY**

As improved flexibility in the application of the business rules is introduced, the interrelationships among the financial management, system, risk and materiality factors will also require further refinement. In addition, the Military Services' and Components' key milestone plans (KMP) will be restructured to coincide with the revised audit readiness strategy. The refinement to the Department's audit readiness strategy and business rules will continue to support sound, effective and sustainable business practices and internal controls.

In addition to refining the audit readiness strategy, revising KMPs and the introduction of the Department's audit committee, several actions across the Department are required to:

- Define segments within the Department's financial environment.
  - By military service
  - By component
  - Within formal audit environment
    - CFO Act of 1990
    - OMB Bulletin 06-03, Appendix B, August 23, 2006
    - Department Financial Management Regulation, Volume 6B, Chapter 1, January 2006
  - Enterprise wide
    - By business process
    - By system and interdependencies

- Determine a timeline for documenting, evaluating, testing and sustaining improvements.
  - By military service and component
  - Enterprise wide, as applicable
- Identify available resources to perform validations, audits and verification of segment sustainment based on timeline and scope of work.
  - Independent public accounting firms
  - Service audit agencies
  - Management
  - External consultant firms

## Other Defense Organizations

Fourteen Defense entities are required to produce auditable financial statements in compliance with the Department's Financial Management Regulation (FMR). Five of those entities receive annual unqualified audit opinions (refer to the accomplishments section of this document) and four of the entities were included in previous FIAR Plans (Service Medical Activity, Defense Logistics Agency, TRICARE Management Activity, and the U.S. Marine Corps). The remaining five entities are introduced in the FIAR Plan for the first time through their accomplishments to-date within their financial improvement initiatives. These Other Defense Organizations are the U.S. Special Operations Command (USSOCOM), Defense Advanced Research Projects Agency (DARPA), Defense Information Systems Agency (DISA), Missile Defense Agency (MDA), and Defense Security Service (DSS).

### Challenges

Although their objectives and operations differ, these organizations often face similar financial management challenges as a result of their relatively small size and relationship to the Military Departments and other, larger Defense entities. In most cases, the ODOs will be able to assert audit readiness only after the Military Services and other entities have addressed weaknesses and asserted audit readiness. Still, the ODOs are making progress and successfully sustaining improvements.

### Accomplishments

The five Other Defense Organizations cited above are committed to attaining audit readiness by improving financial management and correcting internal control deficiencies. This is the first



time that these entities have reported accomplishments in the FIAR Plan. The most significant accomplishments achieved through June 30, 2007, are highlighted below:

<b>ACCOMPLISHMENTS THROUGH JUNE 2007</b>	
	<b>USSOCOM</b> brings the special operations elements of the Army, Navy, Air Force, and Marine Corps together under one worldwide command with control over its own resources.
✓	Completed stand-alone financial statements for FY 2006, and Quarter 1, FY 2007.
✓	Created financial improvement tools, such as process narratives and internal control risk documents, which address OMB Circular A-123, Appendix A, requirements.
	<b>DARPA</b> , the central research and development organization for DoD, pursues research and technology where risk and payoff are both very high and where success may provide dramatic advances for traditional military roles and missions.
✓	Validated FBWT transactions (quarterly since September 2003). FBWT comprises over 98 percent of DARPA's assets. DARPA is sustaining improvements and is prepared to assert audit readiness once the Military Services have completed their assertions.
✓	Validated Accounts Receivable and Accounts Payable (annually since September 2003). DARPA is sustaining improvements and is prepared to assert audit readiness once the Military Services have completed their assertions.
✓	Implemented the DFAS Corporate Database/DFAS Corporate Warehouse for DARPA headquarters accounts and Army allotments (October 2005). The DCD/DCW crosswalks daily transaction data from different Military Service and Defense Agency accounting systems and enables DARPA to collect financial information on all operations at any time. Air Force and Navy allotments should be available in FY 2007.
	<b>DISA</b> plans, engineers, acquires, fields, and supports global net-centric solutions to serve the needs of the President, Vice President, the Secretary of Defense, warfighters and DoD Components, under all conditions of peace and war.
✓	Reconciled or balanced Fund Balance with Treasury (Working Capital Fund) in FY 2006, and Fund Balance with Treasury (General Fund) in January 2007.
✓	Submitted initial draft assertion packages for Accounts Payable, Accounts Receivable, and Cash.

**ACCOMPLISHMENTS  
THROUGH JUNE 2007**

**MDA** develops and fields an integrated, layered ballistic missile defense system to defend the United States, its deployed forces, allies and friends, against all ranges of ballistic missiles in all phases of flight.

✓ Documented the Agency's business processes, including Budget, Accounting, Information Systems, Contracting, and other functional areas.

✓ Provided OMB Circular A-123 internal control training to over 300 employees and contractors.

**DSS** provides the military services, Defense Agencies, 23 federal agencies and approximately 12,000 cleared contractor facilities with security support services.

✓ Corrected the FECA actuarial liability amounts on the DSS financial statements resulting in a \$7.7 million reduction of the actuarial liability being reported.

✓ Reported Property, Plant, and Equipment balances and fully documented the valuation for October 1, 2006, beginning balance in DSS financial statements.