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OCT 5 2010

COMPTROLLER

MEMORANDUM FOR: SEE DISTRIBUTION

SUBJECT: Fiscal Year 2011 Guidance for Implementing Office of Management and Budget (OMB) Circular A-123, Appendix A: Internal Control Over Financial Reporting (ICOFR)

Each year, specified Department of Defense (DoD) Components are responsible for continuously monitoring and improving the effectiveness of internal control over financial reporting and compliance with laws and regulations. In order for the Department to comply with ICOFR, each Component is required to annually assess and report on the adequacy of their internal controls that protect the integrity of the Department's financial reporting.

To successfully accomplish these responsibilities, Components are to establish and implement a clear, organized strategy for complying with OMB A-123, Appendix A, which includes a well defined documentation process that provides verifiable results to support the Component's reporting on the adequacy of controls. The DoD Senior Assessment Team (SAT) oversees DoD compliance with Appendix A and establishes the requirements for the annual evaluation and reporting of results.

Attachment 1 is the DoD SAT annual ICOFR guidance for DoD compliance with Appendix A for the timeframe of July 1, 2010 to June 30, 2011. Attachment 2 is the USD(C) memo dated August 11, 2009 which establishes the improvement of budgetary information (Statement of Budgetary Resources) and the existence and completeness of mission critical assets as priorities. This information is used daily to manage and support our mission. Accordingly, our guidance should support ongoing Financial Improvement/Audit Readiness (FIAR) efforts and minimize unnecessary duplication. As required by the OMB A-123, Appendix A, Components should also consider other items or accounts related to materiality, high risk, or previously reported as auditor identified.

Please contact Ms. Sharon DePrato, DoD ICOFR Program Manager, for more information. She can be reached by email at [Sharon.Deprato@osd.mil](mailto:Sharon.Deprato@osd.mil) or by phone at 703-607-0300 x132.

A handwritten signature in black ink that reads "Mike McCord".

Mike McCord  
Principal Deputy

Attachments:  
As stated

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**DEPARTMENT OF DEFENSE  
OFFICE OF SECRETARY OF DEFENSE (COMPTROLLER)  
A-123, APPENDIX A  
INTERNAL CONTROL OVER FINANCIAL REPORTING GUIDANCE  
FOR  
JULY 1, 2010 – JUNE 30, 2011**

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## I. INTRODUCTION

The Office of Management and Budget (OMB) Circular A-123, Management's Responsibility for Internal Control, defines management's responsibility for internal control in federal agencies. Circular A-123 and the statute it implements, the Federal Managers' Financial Integrity Act of 1982 (FMFIA), are the center of the existing federal requirements to improve internal control. The Circular establishes requirements for conducting management's assessment of the effectiveness of internal control over financial reporting which is required by Appendix A of the Circular. The assessment of Internal Control over Financial Reporting (ICOFR) is a subset of the FMFIA Section 2 assessment.

### A. FMFIA Overview

The FMFIA establishes overall requirements with regard to internal control. FMFIA requires agencies to establish controls that reasonably ensure:

- obligations and costs are in compliance with applicable law;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over assets.

The three objectives of internal control are to ensure the effectiveness and efficiency of operations, *reliability of financial reporting*, and compliance with applicable laws and regulations. The safeguarding of assets is a subset of all of these objectives. The purpose of this guidance is to address requirements related to ICOFR reporting only. Guidance relating to Internal Controls Over Financial Systems (ICOFS) is provided in the Management Internal Control Program (MICP) Guidance and the Financial Improvement and Audit Readiness (FIAR) Guidance.

## II. FMFIA SECTION 2: ICOFR

Department of Defense (DoD) Components are responsible for continuously monitoring and improving the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations. In order for the Department to comply with ICOFR, each Component is required to annually assess and report on the adequacy of their internal controls that protect the integrity of the Department's financial reporting. To successfully accomplish these responsibilities, Components are to establish and implement a clear, organized strategy for complying with FMFIA that includes a well defined documentation process that provides verifiable results to support the Component's reporting on the adequacy of controls.

Overall, the Component's strategy for complying with FMFIA needs to provide management with the information needed to determine whether controls are designed properly and operating effectively. The strategy should serve as the basis for the Component's annual FMFIA certification for internal control over financial reporting. The strategy can leverage activities both internal and external to the Component, such as the following:

- Management knowledge and experience gained from daily operation of Component programs and systems of accounting and administrative controls

- Financial statement audit reports
- Internal control assessments
- Quality assurance reviews
- Management reviews
- Audit reports

Appendix A prescribes a process for assessing internal control over financial reporting. The process includes:

- Establishing a high-level governance body such as a Senior Assessment Team (SAT),
- Evaluating internal control at the entity level by understanding management's attitude, awareness and actions of internal control by ensuring integrity and ethical standards, commitment to competence, management philosophy, organizational structure and assignment of authority and responsibility.
- Evaluating internal control at the process, transaction, or application levels and obtaining knowledge of the organization's key processes by performing process risk assessments with regard to financial assertions of completeness, rights and obligations, valuation, existence and occurrence, presentation and disclosure, compliance with laws and regulations, and safeguarding of assets from fraud, waste, and abuse and identifying existing key controls intended to mitigate identified risk.
- Assessing and testing the design and operation of internal control over financial reporting.
- Documenting the entire assessment process from the establishment of a SAT to the identification of deficiencies and development of corrective action plans.
- Issuing a Statement of Assurance (SOA) of ICOFR as a subset of the Annual Federal Managers' Financial Integrity Act Statement of Assurance.

### III. ASSESSMENT OF ICOFR

This section provides a methodology for successfully completing the assessment of ICOFR based on a Departmental top-down, risk-based approach, which is consistent with the approach outlined by OMB. A summary of the five steps in the Department's approach follows.

- Step 1: Plan for the assessment** by reviewing financial reports, determining key processes, and identifying the internal controls to evaluate.
- Step 2: Evaluate internal control at the entity level** to gain an understanding of management's attitude toward, awareness of, and organizational structure supporting internal control.
- Step 3: Evaluate internal control at the process and application level** by reviewing documented policies, procedures, and process flows to assess the design or absence of internal control.
- Step 4: Test at the transaction level** to determine the operating effectiveness of manual and automated internal controls.
- Step 5: Identify, assess, correct, and report internal control deficiencies.** Among other things, this step includes (1) issuing a SOA on the assessment of the design and operating

effectiveness of internal control over financial reporting, and (2) tracking the prompt and proper resolution and implementation of corrective actions for identified weaknesses.

## **A. Planning**

### **1) Senior Assessment Team**

Each Component is required to have a SAT that oversees the implementation of OMB Circular A-123, Appendix A. The primary responsibilities of the SAT include:

- developing an overall approach;
- ensuring assessment objectives are clearly communicated throughout their respective Components;
- disseminating specific implementation guidance to individuals performing the assessment;
- ensuring the assessment is carried out in a thorough, effective, and timely manner;
- reporting the results of the assessment to senior management; and
- monitoring the prompt correction of weaknesses.

### **2) Focus Areas**

OMB Circular A-123 gives management significant flexibility in designing an evaluation process that meets the needs of each agency and provides a reasonable basis for performing the annual assessment of ICOFR. In establishing a methodology to effectively perform the assessment, DoD management gives consideration to both materiality and risk in determining significant activities and the business processes that will need to be tested by Components.

In compliance with FMFIA, DoD ICOFR requirements must be aligned with efforts to achieve and sustain auditability in the Department. In order to maximize the effectiveness of limited resources for these efforts, the Department has prioritized its financial management and audit readiness efforts to focus on information that is most useful for managers and warfighters. As defined in the Under Secretary of Defense (Comptroller) [USD(C)] memo dated August 11, 2009, this strategic prioritization results in a focus on the Statement of Budgetary Resources (SBR), and the existence and completeness of mission critical assets. As required by the OMB A-123, Appendix A, other areas that should also be considered are those of high risk or focus areas that have been previously reported as auditor-identified resulting in a material weakness.

The Office of the Under Secretary of Defense (Comptroller) FIAR Directorate [OUSD(C) FIAR] has already identified those Components that are material to DoD for the SBR and existence and completeness of mission critical assets. Those Components identified in the chart below are material to DoD financial statements and are required to implement and maintain Financial Improvement Plans, or FIPs. (see *FIAR Guidance*, page 52.) The entities shown below must participate in the ICOFR program and submit deliverables for the indicated financial statement areas.

Reporting Entities	Waves 1 & 2	Waves 3, 4 & 5				
	SBR	Military Equipment	Real Property	Inventory	Operating Materials & Supplies	General Equipment
<b>Preparing for Audit</b>						
Army, GF	√	√	√		√	√
Air Force, GF	√	√	√		√	√
Navy, GF	√	√	√		√	√
Military Retirement Fund Payment*	√					
Defense Logistics Agency, WCF	√		√	√		√
Navy, WCF	√		√	√	√	√
DoD Component Level Accounts	√					
Service Medical Activity	√		√			
Army, WCF	√		√	√		√
Office of the Secretary of Defense (WHS)	√		√			
Pentagon Reservation Maintenance Revolving Fund (WHS)			√			
Unallocated/Undistributed - DoD Component Level Accounts (USD(C))			√			√
Washington Headquarters Services			√			√
Air Force, WCF	√		√	√	√	√
U.S. Special Operations Command	√		√			√
Missile Defense Agency	√		√			
Air Mobility Command	√					
Other 97 Funds Provided to the Army by OSD	√					
Defense Information Systems Agency, WCF	√					
Defense Advanced Research Projects Agency	√					
DoD Education Activity	√					
Tri-Care Management Agency - (FOD)	√					√
Defense Information Systems Agency, GF	√					√
Military Surface Deployment & Distribution	√					
Chemical Biological Defense Program	√					
Defense Security Cooperation Agency	√					
Defense Threat Reduction Agency	√					
Defense Contract Management Agency	√					
Defense Logistics Agency, GF	√		√			
Defense Technical Information Center	√					
United States Marine Corps, GF	√	√	√		√	√
United States Marine Corps, WCF	√		√	√	√	√

\*Military Retirement Fund Payment is not a traditional reporting entity. This entity represents a Treasury account that is only used to receive and disburse appropriations to the Military Retirement Trust Fund.

In accordance with the A-123, Appendix A requirements, the Components listed below have asserted audit readiness, and are still required to maintain their ICOFR programs and support sustainment of these programs by continuing to test controls and validate that all key controls are working efficiently, to include providing their annual ICOFR SOA. (Re: FIAR Guidance, page 52.)

Reporting Entities	Waves 1 & 2	Waves 3, 4 & 5				
	SBR	Military Equipment	Real Property	Inventory	Operating Materials & Supplies	General Equipment
<b>Under Audit</b>						
Military Retirement Trust Fund	√					
U.S. Army Corps of Engineers - Civil Works	√		√	√	√	√
United States Marine Corps, GF	√		√		√	√
Tricare Management Activity – Contract Resource Management	√					
Medicare-Eligible Retiree Healthcare Fund	√					
Defense Commissary Agency	√		√	√		√
Defense Finance and Accounting Service	√					
Defense Contract Audit Agency	√					
Office of the Inspector General, DoD	√					

**a. Additional Areas of Focus**

The Department has identified three additional areas that Components must test to satisfy supplemental requirements issued by OMB or because of the sensitive nature of the area. The testing of the additional areas should be accomplished in conjunction with the testing of the material business processes for ICOFR. Additional focus areas shown below fall within the oversight of the ICOFR program. These focus areas may also have additional reporting requirements that come from other organizations within the Department.

- **American Recovery and Reinvestment Act of 2009**

In February and April 2009, OMB issued guidance and requirements related to implementation of the Recovery Act. Whenever possible, Recovery Act review of activities should be incorporated into existing internal control review activities. Components should ensure that controls documentation exists for each of these areas and that controls are designed properly and operating effectively. If the documentation and testing of key controls for these areas can be satisfied by other internal control assessment activities, such documentation and testing can and should be leveraged. Otherwise, Components will need to develop the appropriate control documentation and conduct necessary testing.

- **Improper Payments Elimination & Recovery Act of 2010**

As required by Appendix C of OMB Circular A-123 (which implements the Improper Payments Information Act, or IPIA), the Department must review all payment programs it administers and identify all such programs that may be susceptible to significant improper payments (OMB guidance has not yet been issued for IPERA, but significant improper payments are defined as 2.5% of program outlays, or \$100 million). The Department must estimate and report the annual amount of improper payments in those programs and report on Recovery Auditing activities also. Improper payments include overpayments, underpayments, payments for services not actually rendered, payments to the wrong individual or group, and even payments to vendors that do not exist.

- **Federal Spending Data Quality**

As required by the OMB memorandum, *Open Government Directive* (M-10-06), dated December 8, 2009, the Department must take specific actions to implement the principles of transparency, participation, and collaboration. OMB also issued specific guidance related to the data quality of Federal spending information that is disseminated to the public including the requirement to develop a data quality framework plan. Internal controls related to Federal spending data compilation, review, dissemination, and monitoring are required to be assessed. Whenever possible, Federal spending data quality review activities should be incorporated into existing internal control review activities.

### 3) Materiality Analysis

Materiality is one of several tools used to determine the scope of the OMB Circular A-123 assessment. Materiality is based on the concept that the items of little importance, which do not affect the judgment or conduct of a reasonable user, do not require direct testing or investigation.

Materiality is defined as the magnitude of an omission or misstatement individually or in the aggregate that, in light of the surrounding circumstances, makes it probable that the judgment of a reasonable financial statement user would have been changed or influenced by such omission or misstatement. Materiality is considered at two levels – an overall level as it relates to the financial statements taken as a whole (Planning Materiality) and an individual account or group of accounts level (Design Materiality).

Planning materiality and design materiality were established at the Department level to identify significant line items within the relevant financial reports.

- **Materiality Base** is the element of the financial statements or a report that is considered to be most significant. The *GAO/PCIE Financial Audit Manual* states that the materiality base generally should be the greater of total assets or expenses (net of intra-governmental balances and offsetting collections).

- **Planning Materiality** is the preliminary estimate of materiality in relation to the financial statements taken as a whole. It is also used to determine whether aggregated misstatements and deficiencies in internal control are material to the consolidated financial statements.
- **Design Materiality** is the materiality level allocated to individual line items and disclosures. Design materiality is used to identify significant accounts and disclosures and to determine the nature, timing, and extent of testing. This type of materiality is a percentage of planning materiality.

DoD has established its level of design materiality for financial statement line items as 0.99 percent of adjusted assets for proprietary accounts and 0.99 percent of total budgetary resources for budgetary accounts. Adjusted assets are calculated by subtracting the total intragovernmental assets (as indicated on the balance sheet) from total assets.

## **B. EVALUATING INTERNAL CONTROL AT THE ENTITY LEVEL**

OMB Circular A-123 requires the Department to perform an entity level assessment to gauge the tone at the top and Department level controls. Evaluating internal control at the entity level allows the Department to obtain an understanding of management's attitude, awareness, and actions concerning internal control. It also provides insight into the internal controls that will ultimately require testing.

The approach developed for the entity level assessment is based on GAO's *Standards for Internal Control in the Federal Government*, November 1999. This framework recognizes the importance of the internal control environment as a key element in the internal control process. There are five standards for internal control as defined by GAO, of which the first four are entity level standards:

- **Control Environment:** the environment "sets the tone" of an organization, provides the discipline and structure, and is the foundation for all other Components of internal control.
- **Risk Assessment:** identification, analysis, and assessment of the relative risks to achievement of entity objectives.
- **Information and Communication:** the information systems that produce reports containing operational, financial, and compliance-related information that make it possible to administer, control, and manage an organization's performance.
- **Monitoring:** the periodic, regular monitoring of systems of internal controls to assess the controls system's performance over a period of time that includes regular management and supervisory activities and other actions personnel take in performing their duties.
- **Control Activities:** the policies, procedures, and practices that help ensure management directives are carried out, including a range of activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

### **1) Assessing Entity Level Controls**

OMB A-123, Appendix A requires that the entity level assessment methodology consists of three phases: (1) collect information through surveys and interviews, (2) identify key entity level controls, and (3) evaluate selected entity level controls. An evaluation strategy should be designed to validate key entity level controls. Appropriate tests of controls should be performed using a combination of inquiry, observation, and inspection to determine whether the controls were applied consistently.

### **2) Considering Controls over Service Providers**

Departmental Components have taken advantage of financial management shared service centers and/or other process outsourcing opportunities to process portions of their financial data. As part of the entity level assessment, each Component is responsible for identifying all significant portions of their material business processes that have been outsourced and the providers of those services. If there has not been a Statement on Auditing Standards (SAS) 70 or a Statement on Standards for Attestation Engagements (SSAE) 16 done in a reasonable timeframe, the Component is still required to perform an assessment over those financial related controls. The Component should never delay their assessment due to not having a current SAS 70/SSAE 16 review available. SSAE 16 will replace the current SAS 70 and is effective for periods ending on or after June 15, 2011. Earlier implementation is permitted.

Components are responsible for reviewing their service provider's SAS 70/SSAE 16 reports to assess the type of review performed, the sufficiency of the review scope, and the results of the review. There are

two types of SAS 70/SSAE 16 reviews – Type I and Type II. The report for a Type I review provides an opinion on the design of internal controls placed in operation by the service organization as of a point in time. (The scope of a Type I review does not include detailed testing of the operating effectiveness of controls.) The report for a Type II review provides an opinion and the supporting results of detailed testing of the operating effectiveness of controls over a period of time, as well as information about the nature, timing, and extent of testing. A Type II review is widely recognized, because it represents that a service provider has been through an in-depth audit of their control activities.

Components should review the SAS 70/SSAE 16 report analyses affecting their material business processes and, particularly, any information regarding key controls that failed testing and the compensating controls Components need to have in place until adequate corrective actions have been taken. It is important that Components incorporate any supplemental controls determined to be key controls into their controls testing for the affected business processes.

## C. EVALUATING INTERNAL CONTROL AT THE PROCESS LEVEL

OMB Circular A-123, Appendix A requires the Department to evaluate internal control at the process level to gain an understanding of the key business processes and related internal controls over those processes. This section addresses Component requirements for documenting processes and controls and assessing control design.

### 1) Documenting Processes and Controls

OMB emphasizes the need to fully document all activities related to the assessment of internal control over financial reporting, which includes key processes and related internal controls. Components are responsible for ensuring all procedural documentation is current, thorough, and consistent with the actual activities performed. Documentation prepared in the previous year's OMB Circular A-123, Appendix A assessment must be modified, as necessary, to reflect current practices prior to performing any testing. The previous year's documentation should also be updated, as necessary, to adequately identify key application controls and information system-dependent controls. Additionally, documentation must be organized and maintained in a manner that makes it readily available for examination by an auditor or other external reviewer.

Internal control process documentation should identify control objectives and link them to the control activities designed to reduce inherent or process risks. The documentation should provide a basic understanding of the flow of transactions, including:

- the individuals responsible for performing each procedure and how often the procedure is performed;
- how transactions are initiated, authorized, processed, recorded, and reported; and
- procedures for correcting and reprocessing previously rejected transactions and correcting erroneous transactions through adjusting entries.

The Department's plan for implementation of OMB Circular A-123, Appendix A, requires all Components to maintain the following process documentation:

- **Business Process Narratives:** Department management should review business process narratives for each process and sub-process. Narratives should be updated to ensure they are current and consistent with tasks being performed, and new narratives should be developed for those processes and sub-processes for which no narrative exists. Each business process narrative should include numbered steps that outline the process, identify the role that perform each step, highlight critical (i.e., key) internal controls, and identify the systems involved in the process or sub-process.

- **Business Process Flows:** Process flows provide a visual representation of the business process and include the decision points and the alternate paths a process may take. Process flows should be linked to business process narratives; each step in the business process should be defined in both document types.
- **Risk Assessments:** The Risk Assessment Template is used to evaluate internal controls and determine whether they adequately address risks. The Risk Assessment Template documents the information needed to develop test plans and evaluate whether a control is a key control and requires testing. Risk Assessment Template is located on the FIAR Tool in the folder titled “ICOFR Templates”.

When documenting the processes, Components should include all three types of controls – manual, application, and information system-dependent controls. Descriptions of control types are provided in the following table.

### DESCRIPTIONS OF CONTROL TYPES

Control Type	Description
Manual	Controls performed by an individual (i.e., review invoice, perform a reconciliation)
Application	Controls performed by a system (e.g., edit or validation checks, file or transaction transmission controls, or automated posting to ledgers)
Information System-Dependent (IS)	Controls that are performed both manually and automatically. For example, a control is manually activated by the user, but the completeness and accuracy of data requested relies on the effectiveness of the system (e.g., electronic evidence or cash balances report from the cash ledger system). This category includes IS controls at the general (e.g., data centers) and application levels. (Re: <i>FIAR Guidance</i> , page 20)

## 2) Assessing Control Design

The documentation of processes and sub-processes provides the foundation of information needed for assessing control design. The information pertaining to process objectives, risks, and controls allows process owners to assess whether controls are designed to achieve process objectives efficiently and effectively, considering the associated risk of error. The assessment of control design efficiency should focus on whether the process is over controlled or there is redundancy in operations. The assessment of control design effectiveness should focus on whether controls are designed to mitigate risks, cannot be bypassed, and will prevent a material misstatement or error from occurring.

If the assessment of control design determines that a key control is not designed to achieve process objectives efficiently and effectively, testing of the “failed control” would not be needed; the conclusion would be that the Component had not yet designed and implemented an adequate control. If this situation is found, Component management will need to identify the compensating controls that mitigate the weakness, take corrective action to ensure an adequate key control is designed and implemented throughout the Component, and then test to ensure it was implemented properly.

## D. TESTING OPERATING EFFECTIVENESS OF CONTROLS

This section addresses Component requirements for testing the operating effectiveness of controls. Specifically, the section addresses requirements for creating a test plan; performing testing; and documenting testing, including the methodology for selecting test samples and key decisions made when

performing testing. All key controls whose design has been deemed effective or moderately effective need to be tested to determine the extent to which the controls were applied and the consistency of their application.

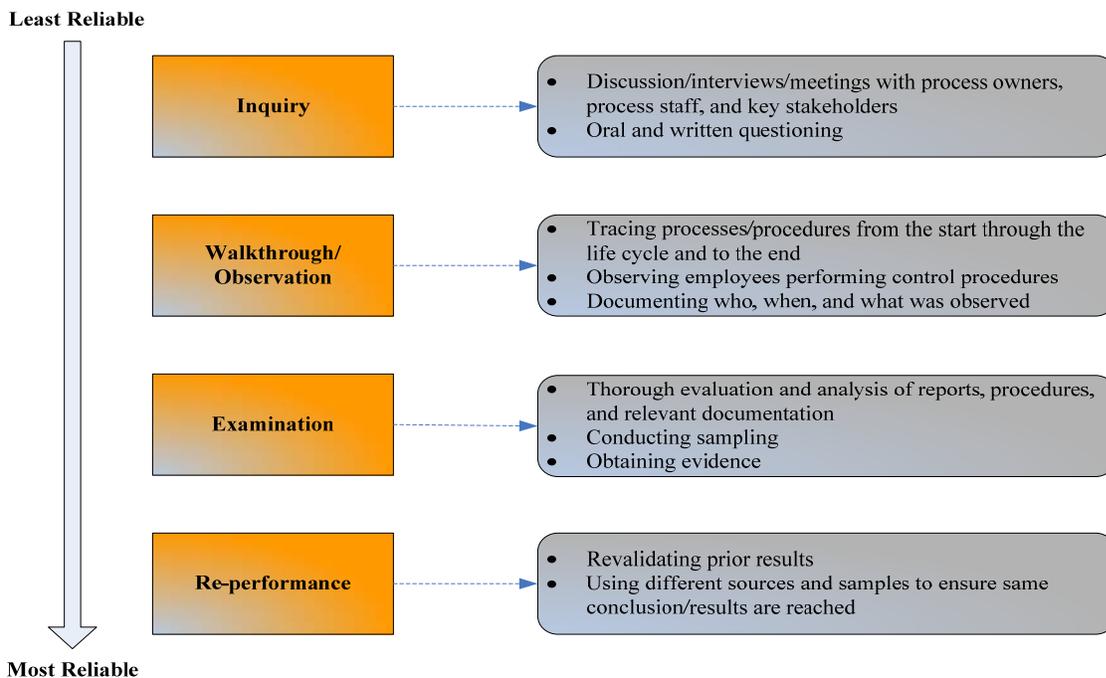
If control gaps identified previously have not been corrected as of the time Components begin testing, the applicable key controls should not be tested until progress has been made to correct the deficiencies. After the deficiencies have been corrected, testing to validate that the deficiencies have been corrected and the controls are operating as intended should be performed using the methods outlined in this section.

## 1) Creating a Test Plan

Components are to create test plans to document the procedures planned to gain evidence to support the operating effectiveness of each key control and identify lapses in the implementation of the controls.

A test plan should be created for each test performed; however, one plan can cover testing of multiple controls, especially if the frequency of the controls and/or the control objectives are the same or similar. (Reference *FIAR Guidance* for Key Control Objectives.)

There are four types of testing methods that can be used to validate if a control is operating effectively: inquiry, walkthrough/observation, examination, and re-performance. It should be noted that for the majority of key controls, an inquiry or walkthrough, alone or combined, would not be sufficient test of controls. Most key controls require attribute testing of a sample of transactions.



## 2) Performing Testing

Components should conduct a walkthrough of each critical process to ensure the process in practice complies with Component requirements. If a walkthrough shows that actual practices circumvent or do not consistently apply key controls established for that process, testing of the operating effectiveness of the “failed key controls” would not be needed; the conclusion would be that the Component has not yet adequately implemented key controls. If this situation is found, Component management should switch to remediation efforts, rather than expend resources testing key controls that are “broken” (not implemented);

i.e., management will need to identify the compensating controls that mitigate the weakness and take corrective actions to ensure key controls are implemented adequately and applied consistently. Once corrected, the key controls will need to be tested.

The timing of testing data used is at the Component's discretion. A suggestion for planning testing is to consider that most financial testing of data is generally performed in two phases – initial testing and final testing. Initial testing is performed on the data available at the time of initial testing, generally the first- and second-quarter data. Final testing is performed later in the assessment period to determine whether controls are continuing to function as intended based on remaining data as it becomes available.

If exceptions are found during initial testing, a Component should consider the results in relation to management's overall evaluation of internal control and determine whether the exceptions potentially indicate there is a deficiency in the design or operating effectiveness of the control, or both. Management's tolerance to an exception may vary depending on the nature of the control and the risk it is designed to prevent. In some instances, one exception noted for a testing attribute could be sufficient for the control to fail testing. In other instances, compensating controls could be in place to lessen the impact of one control failing or one attribute for a control test failing.

When assessing testing exceptions, it is important for management to consider the causes of any deficiency, understand whether it is an isolated event, and determine the accounts or processes impacted. When an exception is found, final testing may require a sample equal to or half of the size of the initial sample to better understand the nature of the exception, and determine whether it was an isolated instance or represents a more pervasive control deficiency.

### **3) Documenting Testing**

To ensure the Department's compliance with OMB Circular A-123, Appendix A assessment documentation requirements, and to facilitate review and use of Component assessments, Components are required to include certain information in the documentation supporting their OMB Circular A-123, Appendix A assessment. For example, all key decisions, including the sampling methodology, and results of testing need to be documented in the test plan. Documentation of the methodology and results should be detailed enough to allow someone to be able to re-perform the testing, and is also the basis for conclusions of whether a control is deemed operating effectively or not. This means that someone should be able to review the same selected items and arrive at the same conclusions.

## **E. IDENTIFYING, ASSESSING, CORRECTING, AND REPORTING INTERNAL CONTROL DEFICIENCIES**

### **1) Identifying Internal Control Deficiencies**

In order to identify internal control deficiencies, DoD Components should document and accumulate all control exceptions found during the control testing of operating effectiveness. A control exception exists when procedures used to evaluate operating effectiveness indicate that a control did not operate as intended. When a Component identifies a control exception, it should consider the results in relation to management's overall evaluation of internal control and determine whether the exception potentially indicates there is a deficiency in the design or operating effectiveness of the control or both.

In addition to any control deficiencies identified during the testing of operating effectiveness, control deficiencies may be identified through other sources, including:

- Management, through a self-assessment of programs
- Management, through its assessment of internal control over financial reporting

- Internal review groups, through the performance of their work
- Service organization SAS 70/SSAE 16 reports
- Services Level Auditors, DoD Office of Inspector General, or GAO audits or reviews
- Weaknesses identified in prior-year financial statement audit reports

Component's need to (1) determine the significance of the control weakness by analyzing the extent of the deficiencies, the effect the weakness will have on the financial statements, and whether compensating controls exist to mitigate the process risk or risk of misstatement and (2) categorize the severity of the weakness, i.e., from internal control deficiency to material weakness, applying the OMB criteria below. The term *material weakness* is used to describe the most serious problems in an organization. Controls that are not working effectively may need to be categorized as reportable conditions or material weaknesses, if adequate compensating controls are not in place. Each deficiency must be assessed to determine if it represents a material weakness.

The OMB definitions for the three categories of internal control deficiencies related to ICOFR and the corresponding reporting requirements are provided in the table on the following page.

## INTERNAL CONTROL DEFICIENCIES OMB DEFINITIONS AND REPORTING REQUIREMENTS

CATEGORY	DEFINITION	REPORTING REQUIREMENT
<b>Control Deficiency</b>	Control deficiencies exist when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A design deficiency exists when a control necessary to meet the control objective is missing or an existing control is not properly designed, so that even if the control operates as designed the control objective is not always met. An operation deficiency exists when a properly designed control does not operate as designed or when the person performing the control is not qualified or properly skilled to perform the control effectively.	Internal to the organization and not reported externally. Progress against corrective action plans should be periodically assessed and reported to agency management.
<b>Reportable Condition</b>	<p><b>FMFIA Section 2</b> – A control deficiency, or combination of control deficiencies, that in management’s judgment should be communicated because they represent significant weaknesses in the design or operation of internal control that could adversely affect the organization’s ability to meet its internal control objectives.</p> <p><b>Financial Reporting</b> – <i>A control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity’s financial statements, or other significant financial reports, that is more than inconsequential will not be prevented or detected.</i></p>	Internal to the organization and not reported externally. Progress against corrective action plans should be periodically assessed and reported to agency management.
<b>Material Weakness</b>	<p><b>FMFIA Section 2</b> – Reportable conditions that the agency head determines to be significant enough to report outside of the agency.</p> <p><b>Financial Reporting</b> – <i>Reportable condition, or combination of reportable conditions, that results in more than a remote likelihood that a material misstatement of the financial statements, or other significant financial reports, will not be prevented or detected.</i></p>	Material weaknesses and a summary of corrective action shall be reported to OMB and Congress through the Annual Financial Report. Progress against corrective action plans should be periodically assessed and reported to agency management.

In determining whether a control exception or deficiency indicates a deficiency in either the design or operating effectiveness of the control, Component management needs to consider various factors, including:

- whether the control is automated (i.e., in the presence of effective general controls, an automated application control is expected to always perform as designed);
- the degree of intervention by personnel contributing to the deviation; and
- if management was aware of the deviation, the actions taken by management in response to the issue.

A significant degree of judgment is required in evaluating whether an internal control deficiency is a reportable condition. Additional factors the assessment team should consider include:

- the frequency of exceptions in the operation of a control;
- the likelihood that the internal control deficiency could result in a misstatement;

- the magnitude of potential misstatements in the financial statements resulting from the internal control deficiency;
- the importance of the control that is deficient, including the degree to which other effective controls achieve the same control objectives; and
- the nature of the account balances or classes of transactions affected by the internal control deficiency and the financial statement assertions involved.

Evaluating whether a reportable condition is also a material weakness is a subjective process that depends on various factors. These may include the nature of the accounting system and of any financial statement amounts or transactions exposed to the reportable condition, the overall control environment, other controls, and the judgment of those making the evaluation. The absence of identified misstatements is not a criterion for concluding that reportable conditions do not constitute material weaknesses.

## **2) Assessing Internal Control Deficiencies**

### **a) Identify and Assess Compensating Controls**

When evaluating internal control deficiencies, Components should identify and assess compensating controls and their impact with regard to mitigating control weaknesses. A compensating control is a technique or other effort designed to mitigate a control design deficiency, ineffective operation or implementation of a control, or the simple lack of control over a financial process or program. If management believes there are compensating controls in place that address the financial statement assertion or risk resulting from the deficiency, management should consider and validate whether the compensating controls:

- would identify an error,
- address the assertion or risk resulting from the deficiency, and
- are effective.

### **b) Assess Deficiencies in the Aggregate**

Components should assess internal control deficiencies in the aggregate to determine if a combination of control deficiencies or reportable conditions represent an overall material weakness. Deficiencies should be assessed to determine whether there is a concentration of deficiencies over a particular process, account, or assertion. For example, assume a particular Component has three internal control deficiencies related to invoice processing. Although none of these deficiencies may individually be a material weakness, they could be considered a material weakness in the aggregate. The assessment of the interaction of deficiencies is essentially a search for patterns (e.g., determining whether the deficiencies affect the same financial statement account and assertions). Components should consider the following in making their assessment of aggregated deficiencies:

- the range or distribution of the amounts of potential misstatement, whether caused by error or fraud, that may result during the same accounting period from two or more individual reportable conditions; and
- the likelihood that such a combination of misstatements would be material.

**c) Assess the Likelihood and Potential Magnitude of a Misstatement**

The determination of *likelihood* is based on the potential that a misstatement would not be prevented or detected, and not necessarily on whether a misstatement has actually occurred. The following factors may impact likelihood:

- the nature of the financial statement accounts, disclosures, and assertions involved;
- the susceptibility of the related assets or liabilities to loss or fraud;
- the subjectivity, complexity, or extent of judgment required to determine the amount involved (i.e., greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);
- the cause and frequency of known or detected exceptions regarding the operating effectiveness of a control;
- the interaction or relationship of the control with the other controls (i.e., the interdependence or redundancy of the control);
- the possible future consequences of the deficiency; and
- the interaction of multiple deficiencies.

Management should consider the total account balance or transaction flow and the assertion that is exposed to risk as a result of the deficiency. The focus should be on the magnitude of the potential error that could occur. The following factors may impact magnitude:

- the financial statement amounts or total of transactions exposed to the deficiencies, and
- the volume of activity in the account balance or class of transactions exposed to the deficiencies that has occurred in the current period or that is expected in future periods.

**d) Make the Final Determination**

The criteria in the “Internal Control Deficiencies” table on page 14 of this guidance, can be used to determine the appropriate category for an internal control deficiency, or deficiencies in the aggregate, after considering compensating controls.

### **3) Developing Corrective Action Plans**

Agency Components are responsible for taking timely and effective action to correct deficiencies identified during assessments of internal control. Correcting deficiencies is an integral part of management accountability and is considered a priority by the Department.

DoD Components are required to develop corrective action plans for all internal control deficiencies categorized as material weaknesses using the Corrective Action Plan (CAP) template. Templates used for ICOFR can be located in a folder on the FIAR Tool titled “ICOFR Templates”. All ICOFR corrective actions must be included in the FIPs. Components are required to update their FIPs monthly, ensuring that the corrective actions in process and milestones are practical and achievable. Rationale must be provided in the FIPs for all corrective action milestone slippage.

## **F. REPORTING REQUIREMENTS FOR ICOFR**

### **1) ICOFR Supporting Documentation**

ICOFR deliverables dates have changed and are now required in phases:

- Phase 1: Process Flows, Narratives and Risk Assessments
- Phase 2: Testing (Test Plans and Control Assessments)
- Phase 3: Assertion Documentation (Re: *FIAR Guidance*, pages 45-57)

Focus areas for submission of documentation can be related to transaction type, such as described below for the SBR:

- Travel (TDY and PCS)
- Payroll (Civilian and Military)
- Contracts (Vendor and Contract Pay)
- Other Obligor Documents (MIPRs, PO, PR's, Requisitions, etc.)

Focus areas should be aligned with systems and business processes, for example, TDY Travel will use the same set of systems for this business process within your Component. SAT Chair Memorandums are required when deliverables are complete and ready for review by FIAR Directorate. When the ICOFR documentation is ready to be reviewed, it is required to be uploaded in the OUSD(C) FIAR tool in the Component's designated ICOFR folder. Please forward the SAT Chair memorandum by email to the ICOFR Program Manager, Sharon DePrato, at [Sharon.deprato@osd.mil](mailto:Sharon.deprato@osd.mil), providing notification that the documentation has been approved by the Component's SAT and is ready for review by the FIAR Directorate. FIAR FIP managers will review work products using criteria stated in section F.3 and will provide feedback to the Component.

In order for testing to be as meaningful and efficient as possible, the Component should work to receive a score of green from the FIAR directorate before moving into Phase 2, testing. Segments can be submitted anytime during the year for review. The Component will not need to wait to have ICOFR documentation reviewed for the entire SBR; they can provide the documentation in segments related to transaction type.

Per Mr. Hale's memorandum dated April 11, 2009, Components are asked to prioritize their focus on SBR and E&C of critical mission assets. The schedule for submitting SAT memorandums and review of deliverables to align with the audit readiness timeframe of assertions relating to SBR and E&C is as follows:

<b>Due Date</b>	<b>Submit to DoD SAT</b>	<b>Goal</b>
4 years prior to assertion (or before)	Component SAT Memorandum includes information pertaining to Process Flows, Narratives and Risk Assessments and states documentation is ready for review.	Score Green before moving to Testing <i>NLT June 30, 2012</i>
3 years prior to assertion (or before)	Component SAT Memorandum includes information pertaining to Test Plans and Control Matrices and states documentation is ready for review.	Score Green before moving to Assertion <i>NLT June 30, 2014</i>
8 months before validation of audit readiness	FIAR Governance Board Representative submits memorandum stating internal controls support audit readiness.	FIAR and IG determine documentation is ready for examination. <i>NLT March 31, 2017</i>

As stated above, the Component will be required to have completed and reviewed all SBR and E&C documentation for ICOFR deliverables no later than (NLT) the following dates:

- All process flows, narratives and risk assessments must achieve a green score NLT June 30, 2012.
- All testing must achieve a green score NLT June 30, 2014.
- FIAR and IG determine documentation is ready for examination NLT March 31, 2017.

## 2) Annual ICOFR SOA Reporting

Due Date: September 1, 2011

Requirements: All annual reporting requirements for the Annual Statement of Assurance for Internal Control over Financial Reporting are found in the following guidance: *Managers' Internal Control Program and Instructions on the Preparation of the Annual Statement of Assurance (SOA)*.

## 3) ICOFR Scorecards

In 2010, the OSD SAT approved the following scorecards for reporting on the progress of the Components' ICOFR deliverables. FIP managers will relay these scores back to the Components during the year. A consolidated report of all of the Component's scores will be provided annually to the OSD SAT.

<b>ICOFR DELIVERABLES SCORING CRITERIA</b>	
<b>Control Environment Documentation</b>	
<b>Blue</b>	100% of all Checklist Questions Exceptional in all aspects: <ul style="list-style-type: none"> <li>• Program is in alignment with the OUSD(C) FIAR priorities,</li> <li>• SAT Charter and Membership have cross-functional members of the organization,</li> <li>• Organization Charts are provided at the proper level,</li> <li>• Ethics Policy is included and training is noted,</li> </ul>
<b>Green</b>	≥80% of all Checklist Questions Acceptable in all aspects: <ul style="list-style-type: none"> <li>• SAT Charter and Membership have cross-functional members of the organization,</li> <li>• Organization Charts,</li> <li>• Ethics Policy</li> </ul>
<b>Yellow</b>	≥50-80% of all Checklist Questions Acceptable in most aspects: <ul style="list-style-type: none"> <li>• SAT Charter and Membership,</li> <li>• Organization Charts,</li> <li>• Ethics Policy</li> </ul>
<b>Red</b>	<50% of all Checklist Questions Unsatisfactory <ul style="list-style-type: none"> <li>• SAT Charter and Membership,</li> <li>• Organization Charts</li> </ul>

<b>ICOFR DELIVERABLES SCORING CRITERIA</b>	
<b>Process Flows, and Narratives</b>	
<b>Blue</b>	100% of all Checklist Questions Exceptional in all aspects: <ul style="list-style-type: none"> <li>• Program is in alignment with the OUSD(C) FIAR priorities,</li> <li>• Process Flows and Narratives are accurate, complete, and easy to comprehend.</li> <li>• Process Flows and Narratives clearly depict all key controls.</li> <li>• Narratives describe who performs the process, what system performs the process, if the control is manual or automated, and the reconciliation procedures involved in ensuring the control works as intended.</li> <li>• Process Flows and Narratives describe all steps in the business process and can be used as a standard model for this focus area for other organizations in the Department.</li> </ul>
<b>Green</b>	≥80% of all Checklist Questions Acceptable in all aspects: <ul style="list-style-type: none"> <li>• Process Flows and Narratives are accurate, complete, and easy to comprehend.</li> <li>• Process Flows and Narratives clearly depict all key controls.</li> <li>• Narratives describe who performs the process, what system performs the process, if the control is manual or automated, and the reconciliation procedures involved in ensuring the control works as intended.</li> </ul>
<b>Yellow</b>	≥50-80% of all Checklist Questions Acceptable in most aspects: <ul style="list-style-type: none"> <li>• Process Flows and Narratives lack consistency in at least one step or the step described is incomplete. Unable to walk-thru process flows without clarification or comprehend steps described in narratives.</li> <li>• Process Flows and Narratives describe controls but not key controls.</li> <li>• Narratives do not fully describe at least one event that involve roles (such as separation of duties) required in completing specific steps in the process.</li> </ul>
<b>Red</b>	<50% of all Checklist Questions Unsatisfactory <ul style="list-style-type: none"> <li>• Process flows and narratives are incomplete for two or more steps described in the process. Unable to walk-thru process flows without clarification for two or more steps within the process described.</li> <li>• Process Flows and Narratives describe controls but not key controls.</li> <li>• Narratives do not describe more than two events that involve roles (such as separation of duties) required in completing specific steps in the process.</li> </ul>

<b>Risk Assessments</b>	
<b>Blue</b>	<p>100% of all Checklist Questions                      Exceptional in all aspects:</p> <ul style="list-style-type: none"> <li>• Risk Assessments are accurate, complete, and easy to comprehend with respect to the objective of assessing reasonable assurance regarding the five key accounting assertions.</li> <li>• Risk Assessments define all risk on all key controls and controls tie back to process flows and narratives and every control links to at least one risk.</li> <li>• Risk Assessments are thorough and describe not only the control but the role that performs the activity related to the control. Controls described should be for all categories such as physical asset controls, system based controls, document controls, reconciliation controls and approval or authorization controls.</li> </ul>
<b>Green</b>	<p>≥80% of all Checklist Questions                      Acceptable in all aspects:</p> <ul style="list-style-type: none"> <li>• Risk Assessments are accurate, complete, and easy to comprehend.</li> <li>• Risk Assessments define all risk on all key controls and controls tie back to process flows and narratives and every control links to at least one risk.</li> </ul>
<b>Yellow</b>	<p>≥50-80% of all Checklist Questions                      Acceptable in most aspects:</p> <ul style="list-style-type: none"> <li>• Risk Assessments lack consistency or are incomplete. Unable to walk-thru risk assessments without clarification.</li> <li>• Risk Assessments define all risk on controls and controls tie back to process flows and narratives and every control links to at least one risk.</li> </ul>
<b>Red</b>	<p>&lt;50% of all Checklist Questions                      Unsatisfactory:</p> <ul style="list-style-type: none"> <li>• Unable to walk-thru risk assessments without clarification or fully comprehend presentation of information.</li> </ul>

<b>ICOFR DELIVERABLES SCORING CRITERIA</b>	
<b>Testing</b>	
<b>Blue</b>	<p>100% of all Checklist Questions                      Exceptional in all aspects:</p> <ul style="list-style-type: none"> <li>• Program is in alignment with the OUSD(C) FIAR priorities,</li> <li>• SAT Memorandum is signed by SAT Chair and focus areas are specifically identified,</li> <li>• Control Assessments are accurate, complete, and easy to comprehend with respect to the objective of assessing reasonable assurance regarding the five key accounting assertions.</li> <li>• Control Assessments define risk(s) on all key controls and all key controls tie back to process flows and narratives.</li> <li>• Control Assessments show successful test results with few exceptions.</li> <li>• Control Assessments depict future testing as reduced due to meeting test objectives resulting in compliant internal controls.</li> </ul>
<b>Green</b>	<p>≥80% of all Checklist Questions                      Acceptable in all aspects:</p> <ul style="list-style-type: none"> <li>• SAT Memorandum is signed by SAT Chair and focus areas are specifically identified,</li> <li>• Control Assessments are accurate, complete, and easy to comprehend.</li> <li>• Controls define risk(s) for all key controls identified and all key controls tie back to process flows and narratives.</li> <li>• Control Assessments show risk is reassessed dependant on test results.</li> </ul>
<b>Yellow</b>	<p>≥50-80% of all Checklist Questions                      Acceptable in most aspects:</p> <ul style="list-style-type: none"> <li>• SAT Memorandum is signed by SAT Chair and focus areas specifically identified.</li> <li>• Control Assessments lack consistency with proper assessment of risk levels or one or more controls have not been assessed properly.</li> <li>• Control Assessments require clarification in at least one column of the control assessments required template criteria.</li> <li>• Control Assessments identify some key controls but mostly overall controls in general have been identified.</li> </ul>
<b>Red</b>	<p>&lt;50% of all Checklist Questions                      Unsatisfactory</p> <ul style="list-style-type: none"> <li>• SAT Memorandum signed by SAT Chair and focus areas not identified,</li> <li>• Unable to walk-thru Control Assessments without clarification or unable to fully comprehend presentation of test results information shown on Control Assessments.</li> <li>• More than one testing objective was not met and test results were inconclusive.</li> <li>• Testing has not been conducted for all focus areas identified on SAT Memorandum.</li> </ul>



COMPTROLLER

UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100

AUG 11 2009

MEMORANDUM FOR SECRETARY OF THE ARMY  
SECRETARY OF THE NAVY  
SECRETARY OF THE AIR FORCE  
UNDER SECRETARY OF DEFENSE FOR ACQUISITION,  
TECHNOLOGY, AND LOGISTICS  
UNDER SECRETARY OF DEFENSE FOR PERSONNEL  
AND READINESS  
DEPUTY UNDER SECRETARY OF DEFENSE  
(INSTALLATIONS AND ENVIRONMENT)  
ASSISTANT DEPUTY CHIEF MANAGEMENT OFFICER  
DIRECTORS OF THE DEFENSE AGENCIES  
DIRECTOR, TRICARE MANAGEMENT ACTIVITY

Subject: Priorities for Improving Financial Information and Processes and Achieving  
Audit Readiness

This memorandum outlines the priorities the Department of Defense (DoD) will follow with regard to improving its financial information and processes and for achieving audit readiness.

Background:

The Chief Financial Officers (CFO) Act of 1990, along with subsequent legislation, requires that federal agencies produce auditable financial statements. The first and most important step in this process requires improving financial information to make it more useful and reliable for managers. Unqualified audit opinions are one result of this effort and serve useful purposes. They verify improvements in information and processes and provide independent reassurance to the public that DoD is a good steward of their tax dollars.

In recent years, the DoD has made progress toward improving financial information and processes supporting auditability. For example, the Army Corps of Engineers improved its financial information and achieved an unqualified audit opinion in 2008, and the United States Marine Corps is close to being ready for audit of its Statement of Budgetary Resources.

However, many of the hardest problems remain unresolved, including implementing compliant systems and valuing our significant investment in property and

equipment. The remaining tasks will be daunting both because of the Department's size and complexity and because of the need to involve many functional communities that have pressing operational and management commitments. Further, some of the information required for a formal audit – including valuations of assets – is of limited use to DoD managers.

Priorities:

In order to focus limited resources in the most effective manner, I am directing that DoD pursue specific priorities as follows with regard to improving financial information and processes supporting audit readiness.

- In compliance with the law, the DoD Components will continue to work toward financial improvements that permit all their financial statements to receive unqualified audit opinions. DoD will also continue to place its primary emphasis on improving financial information and processes so that the information is more useful to managers. Successful audits will be one result of these improvements.
- DoD Components will focus first on improving information and processes supporting auditable statements for the financial information that is most often used to manage the Department. Because budgetary information is used widely and regularly for management, DoD will place the highest priority on improving its budgetary information and processes. That will eventually lead to unqualified opinions on the Statements of Budgetary Resources. A secondary goal will be to verify the existence and completeness of mission critical assets (that is, verifying that records accurately capture the number of each type of weapon system, real property, inventory, and operating materials and supplies). DoD Components will place a lower priority on valuing assets and on improving other information on their balance sheets but may continue to work in these areas.
- DoD Components are directed to adjust their current plans in August 2009 for improving financial information and processes and achieving successful audits to focus first on their Statements of Budgetary Resources. Then, focus on existence and completeness of mission critical assets. Once DoD Components have improved information and achieved successful audits in these higher priority areas, they may increase the priority placed on asset valuation and other balance sheet items.

While the financial management community is the leading advocate for this initiative, efforts to improve financial information must involve many functional communities and the Chief Management Officers who broadly direct business operations. Please distribute this memorandum widely to all those in your organization who are

responsible for improving financial information and processes and for achieving audit readiness.

My point of contact for this action is Ms. Radha Sekar. She may be reached by phone at (703) 697-3200 or by email at [radha.sekar@osd.mil](mailto:radha.sekar@osd.mil).

A handwritten signature in cursive script that reads "Robert F. Hale".

Robert F. Hale

Cc:  
DoDIG