



UNDER SECRETARY OF DEFENSE

1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

JUN 23 2004

COMPTROLLER

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
INSPECTOR GENERAL OF THE DEPARTMENT OF
DEFENSE
DIRECTORS OF THE DEFENSE AGENCIES
COMMANDER, SPECIAL OPERATIONS COMMAND
COMMANDER, U.S. ARMY CORPS OF ENGINEERS

SUBJECT: Financial Improvement Initiative Business Rules

The Military Departments, Defense Agencies, and other primary fund-holders have prepared improvement plans to ensure the Department achieves an unqualified audit opinion on the fiscal year (FY) 2007, Department of Defense (DoD)-wide financial statements. To ensure a disciplined structure through the process, I have attached business rules to guide the Components and other primary fund holders, as well as the Inspector General, Department of Defense (IG, DoD).

You are required to comply with the following five phases in the attached business rules:

- Discovery and correction phase: Management identifies deficiencies and implements corrective actions.
- Validation phase: Management validates financial information after corrective actions are completed.
- Assertion phase: Management asserts to IG, DoD the reliability of the financial information.
- Assessment: IG, DoD does limited review of financial information to determine if it is ready for audit.
- Audit: IG, DoD audits the organization's financial statements that management asserted were ready for audit and that passed IG, DoD assessment.

By diligently following the attached business rules and closely monitoring your improvement plans, we can reach our goal of receiving an unqualified opinion on the DoD-wide financial statements in FY 2007. I appreciate everyone's hard work in achieving this goal.

My point of contact for these business rules is Mary Braun. She can be reached at (703) 693-6505 or by e-mail at mary.braun@osd.mil.


Lawrence J. Lanzilotta
Acting

Attachments:
As stated

Financial Improvement Initiative Major Phases*

DISCOVERY AND CORRECTION PHASE	VALIDATION PHASE	ASSERTION	ASSESSMENT	AUDIT
<p>WHY?</p> <ul style="list-style-type: none"> • Implement 1008.** • Discover problems. • Evaluate solutions. • Plan solutions. • Correct processes. • Complete policy. • Complement Business Management Modernization Program. <p>HOW?</p> <ul style="list-style-type: none"> • Develop improvement plans. • Establish audit committees. • Develop systems strategy. • Prepare business cases for systems changes. • Prepare and review full set of financial statements each quarter. 	<p>WHY?</p> <ul style="list-style-type: none"> • Implement 1008. • Enhance credibility of assertions. <p>HOW?</p> <ul style="list-style-type: none"> • At beginning, coordinate and obtain comment from IG, DoD and notify Review and Prioritization Subcommittee. • Management documents processes, identifies controls & systems, and ensures auditable universe of transactions & supporting documentation is available. • Management requests validation of financial information. • Performed by Internal Review, Component's Audit Agencies, or external audit firm. 	<p>WHY?</p> <ul style="list-style-type: none"> • Communicate to IG, DoD and auditors reliability of financial information. <p>HOW?</p> <ul style="list-style-type: none"> • Assertion Letter to IG, DoD. <ul style="list-style-type: none"> ◦ Respond to IG, DoD's instructions. ◦ Checklist. ◦ Results of validation and reports. • Agreement with engagement letter and management representative letter, if used. • Memo to IG, DoD, copy to OUSD(C) Review & Prioritization Subcommittee. • ESC approval for assessment/audit required before IG, DoD obligates funds for assessment/audit contracts. 	<p>WHY?</p> <ul style="list-style-type: none"> • Implement 1008. • Allows remediation. • Attests to management assertion. • Plan audit. • Reduce risk of unknowns (auditor). • Introduction to organization (auditors). <p>HOW?</p> <ul style="list-style-type: none"> • IG, DoD oversight of IPAs. • IG, DoD in-house. 	<p>WHY?</p> <ul style="list-style-type: none"> • Implement CFO Act. • Implement 1008. • Presidents' Management Agenda. <p>HOW?</p> <ul style="list-style-type: none"> • Pass assessment. • IG, DoD oversight of IPAs.

*Acronyms are explained within the Assertion Process Business Rules
**Fiscal Year 2002 National Defense Authorization Act, Section 1008

Financial Management Improvement Initiative Assertion Process Business Rules

Introduction

Section 1008 of the “National Defense Authorization Act for Fiscal Year 2002” requires that the Under Secretary of Defense (Comptroller) (USD(C)) assess the reliability of the Department of Defense (DoD) financial statements, including the financial statements of each component of the Department. For those statements expected to be unreliable, the USD(C) is to minimize resources expended on financial statement preparation, consistent with the benefits to be derived and redirect resources to corrective actions. Entities that prepare financial statements will prepare preliminary representation letters regarding the reliability of their financial statements.

Section 1008 further requires that, for each financial statement asserted to be unreliable, the Office of the Inspector General of the Department of Defense (IG, DoD) shall only perform the audit procedures required by generally accepted government auditing standards, consistent with any representation made by management. Once a reporting entity represents that its financial statements are reliable, Section 1008 no longer applies to that entity, and the IG, DoD will perform a full financial statement audit of the entity.

The Business Rules provide the framework which DoD leadership should use to move their entities’ financial statements from a position of unreliability to that of reliability and, ultimately, to an unqualified audit opinion.

Background

For purposes of identifying and meeting the requirements of the fund holders within the DoD, they have been grouped into four categories as follows:

- Tier 1: Entities directed by Office of Management and Budget to prepare audited financial statements and the Medicare Eligible Retiree Health Care Fund,
- Tier 2: Intelligence Agencies,
- Tier 3: Entities directed by the DoD to prepare stand-alone financial statements,
- Tier 4: All other DoD Agencies, entities, and funds. Although not required to prepare financial statements, Tier 4 entities should prepare improvement plans to ensure their trial balances are auditable.

Discovery and Correction Phase

The purpose of the Discovery Phase is to identify obstacles which would prevent the entity from obtaining an unqualified audit opinion and to prepare improvement plans with solutions that have measurable outcomes for overcoming those obstacles.

- Entities will prepare a financial improvement plan, in accordance with the appropriate USD(C) memoranda dated August 8, 2003, or September 18, 2003, for achieving an unqualified audit opinion of their financial statements.
- Entities will identify in their plans, by financial statement line item, all known deficiencies relating to the line item which cause an erroneous presentation of that line item. Deficiencies could include accounts requiring correction and processes

requiring improvement in order to achieve an unqualified audit opinion on the entity's financial statements. To prioritize corrective actions, entities should identify deficiencies that have a material impact on the financial statements in consultation with internal and external auditors.

- Entities will prepare comprehensive corrective action plans to resolve the identified deficiencies, identify measurable steps, with completion dates, to ensure each applicable item identified in the plans is addressed and resolved.
- Include in the corrective action plans any requirement for systems audits which would need to be performed so reliance can be placed on the systems when an audit is performed.
- If current systems must be modified and the modifications are part of the corrective actions, entities will prepare a business case to support the modification to be provided to the Business Modernization Management Program Office and advise the assigned USD(C) point of contact.

As part of the Discovery/Correction Phase, DoD entities should implement the solution sets, within the milestone dates prescribed, resulting in a resolution of the identified discrepancy. This phase is anticipated to be multi-faceted and incremental. All corrective action steps are not expected to be completed on the same date.

- Entities will aggressively pursue corrective actions identified in the improvement plans to resolve all known deficiencies by designated milestone dates.
- Management personnel and audit committees at each activity will closely monitor progress to ensure actions taken are to achieve the intended result in the time allotted.
- As corrections are ongoing, it is anticipated that new deficiencies may be identified. As this occurs, activities will coordinate with OUSD(C) points of contact to modify plans to include any such additions.
- Requests for extension of dates should include actions taken to date, reason for date slippage, new proposed completion date, and plan for getting back on track to meet the next original milestone date.

Validation Phase

The purpose of the Validation Stage is to validate that the corrective actions have effectively overcome previously identified deficiencies identified in the Discovery Stage and deficiencies identified during the Correction Phase and to determine if sufficient controls and transaction information are available to support management's assertion that the line or statement is ready for audit.

A validation is a limited scope evaluation or review to determine whether previously identified deficiencies in an entity's financial statement(s) or line have been satisfactorily remedied. This review is the responsibility of management and may be performed by management, internal auditors, or a contractor. The scope of specific procedures required for each validation are the responsibility of management and will be determined in the context of the materiality of each issue or action taken in that circumstance. This process is primarily for management to determine if their statement or line is ready for an assessment or audit by the IG, DoD. If management determines that the statement or line is ready for an assessment or audit, the work accomplished during the validation may be used by the IG, DoD. It is important

that the IG, DoD be aware of the validation technique being performed by the entity prior to the initiation of the validation process to facilitate the assessment process after the entity submits its assertion package. The IG, DoD has no defined role in the conduct of a validation.

- At the beginning of the Validation Stage, entities will notify the IG, DoD by memorandum, with a copy furnished to OUSD(C) points of contact, of the entity's intent to validate a line or statement and the corrective actions taken to resolve deficiencies. The notification will include the intended method for validating that the corrective action did correct the known deficiency and that the line or statement is ready for audit. Although the IG, DoD has no specific role in the validation phase, the IG, DoD may, in an advisory capacity, comment on any obvious flaws or items of concern related to the validation methodology. The OUSD(C) points of contact will notify the Review and Prioritization Subcommittee (RPS). The RPS will notify the Executive Steering Committee (ESC) and, if any concerns exist, the ESC will provide a memorandum to the entity conveying its concerns.
- During the Validation Stage, the entity will perform a validation of the resolution of the identified deficiencies. Validation may be performed by Internal Review, Independent Public Auditors, or by internal management reviews. These validations are being performed at the request of and under the oversight of management. Audit committees should be actively engaged in overseeing the progress of the validation process.
- During the Validation Stage, management will complete the attached checklist (Attachment 4) in preparation for assertion. The checklist includes such steps as documenting processes, identifying controls, and preparing an auditable universe to be used during the assessment and audit phase. The checklist will be an attachment in management's assertion package.
- The validation process, in preparation for audit, will also ensure that supporting documentation is available for audit.

Assertion Phase

The purpose of the Assertion Phase is to notify the IG, DoD that validation of corrected deficiencies have been completed and that a financial statement or line item is ready for audit. During the Assertion Phase, management will prepare an assertion memorandum asserting audit readiness and a package of accompanying documentation to support the position of audit readiness.

- Entities will prepare an assertion package and submit it to IG, DoD, with copy furnished to the OUSD(C) point of contact who will forward it to the RPS.
- The assertion package will contain the following:
 - Management assertion letter, prepared in accordance with IG, DOD memorandum, "Management Assertions," October 15, 2003 (Attachment 5), asserting audit readiness of the line or statement which has been validated, using the attached (Attachment 3) assertion letter template,
 - A summary of the validation work performed and an explanation of actions taken by management to resolve deficiencies,
 - Reports resulting from the validation, and
 - The checklist which was completed during the Validation Phase (Attachment 4).
- If the entity prepares an engagement letter or a management representation letter for

IG, DoD, subsequent representation letters should reflect management's assertions in the engagement or representation letters.

- The IG, DoD will receive the assertion package and determine, based on the information in the assertion package, other pertinent knowledge, and Section 1008, whether it will conduct an assessment of the entities line or statement or whether it will bypass the Assessment Phase and proceed to the Audit Phase.
- The IG, DoD will notify the RPS of assertions received, and advise the committee if the assertion letter will result in an assessment or an audit. The IG, DoD will also provide a cost estimate for the assessment or audit. Note: It is IG, DoD's judgment whether to assess or audit.
- The RPS will review improvement plans, representation letters, and IG, DoD recommendations and develop prioritized recommendations for assessment and audit schedules to present to the ESC. The Funding Subcommittee will also review the recommendations of the RPS for funding issues. The recommendations for assessment and audit will be presented to the Financial Management Improvement Plan ESC for approval and prioritization. Recommendations presented to the ESC will address scope limitations that may be imposed on the assessments or audits.
- Entities will be notified when they are approved for assessment or audit.

Assessment Phase

The purpose of the Assessment Phase is to assess the reliability of the line or statement which the entity asserted as being ready for audit. Assessment will generally be done first if a statement has never been audited. Assessment could also occur when the IG, DoD believes circumstances may exist which would cause the entity to obtain an opinion other than unqualified and determines that an assessment is necessary to ensure reliability as required in Section 1008. During the Assessment Phase, an entity may perform remediation in the event a deficiency is identified which would prevent an unqualified opinion.

The assessment will be performed by the IG, DoD or by an Independent Public Accountant (IPA) contracted to perform work for the IG, DoD, after the ESC has approved the assessment. The scope of the assessment will be determined in accordance with the General Accounting Office Financial Audit Manual and will consist of accomplishing the audit steps outlined in the Planning Phase and Internal Control Phase of the audit manual. The assessment process will determine whether the entity can likely achieve an unqualified audit opinion. In the event that it is determined that circumstances or problems exist that preclude an unqualified opinion, a report will be written to management that describes what has prevented the auditor from obtaining sufficient, reliable and competent information regarding the reliability of reported information. The report will recommend to management what needs to be accomplished to remedy the problems.

The Assessment Phase will be used as part of the IG, DoD's audit strategy to reduce risks of the unknown and introduce new auditors to the entity's processes.

- 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 any new deficiencies identified. There will be continued communication, both written and oral, as the assessment progresses.
- Management should take actions to correct problems identified during the assessment.

- The IG, DoD will recommend when it is appropriate to move forward with a formal audit.

Audit Phase

The purpose of the Audit Phase is to obtain an auditor's opinion of the condition of an entity's financial statement line or an auditor's opinion on the fairness of the presentation of the information in the financial statements. When a financial statement or portion thereof is asserted to be ready for audit and has passed assessment, or assessment has been waived, the IG, DoD will determine the appropriate scope and nature for financial audit and the associated reports.

During the Audit Phase, the entity and its accounting records will be audited to determine if the balances and related notes presented on its financial statements fairly represent the operations of the entity.

- With the assistance of the IG, DoD, components will prepare detailed engagement letters requesting audit services.
- Components will prepare as many interim management representation letters as necessary which would include any additional assertions to date.
- Components will prepare a final management representation letter.
- Deficiencies will be immediately addressed with a written plan for resolution, including projected resolution date.
- The IG, DoD will intervene if necessary to end the audit and recommend a follow-up assessment upon indication that the audit may not have a favorable outcome.

SAMPLE MANAGEMENT ASSERTION

MEMORANDUM FOR INSPECTOR GENERAL OF THE DEPARTMENT OF
DEFENSE

SUBJECT: Management Assertion for (fill in line item/financial statement)

This memorandum is to inform the Inspector General of the Department of Defense that the (ie: Army General Fund) has completed corrective actions of the material deficiencies on the (ie: Accounts Receivable) line item on the (ie: balance sheet). (ie: Accounts Receivable) is fairly presented in accordance with generally accepted accounting principles and is ready for audit. We have also completed the attached checklist indicating our preparedness.

We completed the following actions to correct the known material deficiencies in this area:

(From step 6 of the attached checklist – using the corrective actions detail from your Mid-Range Financial Improvement Plans, list the specific corrective actions performed to fix all known deficiencies in this area. Be very specific. If the explanation is extensive, consider referring to an attachment for the detailed explanation)

We have sufficient audit-ready evidential matter to support the transactions that constitute the (ie: Accounts Receivable) balance shown on the (ie: balance sheet). The documentation can be provided to the auditors within a reasonable amount of time. We request that the auditors provide our field sites a data request list at least three weeks prior to arriving in the field.

We understand that significant accounting resources are required to support an audit. We have sufficient knowledgeable staff available to support audit requests during audit fieldwork. We request that the auditors alert us at least three weeks prior to visiting a field site, so we can adjust schedules to accommodate the anticipated workload to support the visiting auditors.

Signed by agency financial manager/CFO

cc: OUSD(C)

Attachment
As stated

CHECKLIST

When performing corrective action validation and while preparing the assertion package, please complete the following checklist. Include the completed checklist as an attachment to your assertion letter.

This check list is designed to help components prepare for audits by providing the information that is typically needed for financial statement audits. Keep in mind that the list of specific items you will need for an assessment or audit will come from the auditors in the form of a "Prepared By Client (PBC) List."

The following steps may begin during the Discovery Phase or Correction Phase to assist those performing the assessment in validating that these steps have been completed.

- 1 Identify and document the procedures, processes, and control points for deriving the balance(s) being asserted. Include the systems that are used and the flow of data from field level to departmental level. This can be done in a cycle memorandum or flow chart format. Having this information prepared in advance will be a great tool for you to refer to during the assessment and audit. Also, the auditors will need to document the information so you will already have the information prepared. Be sure to identify all systems that have detail that makes up the balance(s) being asserted as ready for audit.
- 2 Have all General Ledger transaction detail and supporting information from feeder systems available for all the transactions that make up the balance(s) being asserted. Ensure the total of the detail equals the balance of the line item. This includes all accounting adjustments that have an effect on the ending balance of a line item reported on the financial statements.
- 3 Consolidate evidential matter that supports the transactions in step 2 or map where the evidential matter is located for easy and expedient retrieval.
- 4 Prepare a summary of the validation work performed by management Service auditors, internal auditors, or independent public accounting firms to establish audit readiness, if applicable.
- 5 Complete all the corrective actions in your Mid-Range Financial Improvement Plan for the material deficiencies related to the balance(s) being asserted.
- 6 Using the information from number 5 above, prepare an explanation of the actions taken to fix previously identified or existing problems and incorporate the explanation in the assertion letter or include as attachment to the letter. Be very specific.
- 7 Compile organization charts indicating key personnel and their responsibilities and phone lists.
- 8 For all the systems identified in step 1 above, has there been a Financial Information Security Audit Manual Controls (FISCAM) or Statement of Auditing Standard (SAS) 70/88 audit conducted on the systems?
 - Yes If yes, provide the date and point of contact.
 - No

- 9 For the Systems identified in step 1 that you answered Yes in step 8, obtain a copy of the FISCAM or SAS 70/88 audit report and skip the rest of the steps. For the systems identified in step 1 that you answered No in step 8, proceed to step 10.

If a FISCAM or SAS 70/88 audit has not been conducted on the system, then the auditors will have to perform alternate procedures on the system. Therefore, the following information will have to be gathered prior to the audit for each system.

- 10 Prepare a description of the major hardware and software of the system and interfaces with other systems
- 11 Describe what type of data the system produces for the financial statements, e.g. accounting transactions
- 12 Prepare a description of telecommunications devices and networks used with the system.
- 13 Obtain a copy of the most recent certifications and accreditations of the system.
- 14 Identify the system location(s) and end user locations.
- 15 Identify the location(s) of system documentation.
- 16 Identify the type, dollar value, and number of transactions processed in the system in a month and in a year.
- 17 Obtain a list of all system users - this should be a print out that shows the user and level of access.
- 18 Inquire if there are any ongoing or planned system reviews - if there are, determine when the reviews will be complete.



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202-4704

OCT 15 2003

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/
CHIEF FINANCIAL OFFICER
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTORS OF THE DEFENSE AGENCIES
COMMANDER, U.S. ARMY CORPS OF ENGINEERS

SUBJECT: Management Assertions

The process that Office of the Inspector General of the Department of Defense (OIG DoD) auditors will follow when DoD financial managers represent that a financial statement or line item is ready for audit will be performed in two phases. A proposed schedule of phase one and phase two completion dates, by line item or statement, was provided in the Under Secretary of Defense (Comptroller)/Chief Financial Officer (USD[C]/CFO) August 8, 2003, memorandum.¹ During phase one, the audit clients will ensure that financial statements and supporting documentation are ready for audit. For phase two, we intend to assess audit readiness prior to contracting with independent public accountants (IPAs) to perform the specific audits. DoD financial managers should support their management assertions² by providing OIG DoD auditors with the following items prior to auditors initiating assessment efforts:

- an explanation of the actions taken by management to fix existing problems;
- a statement that sufficient audit-ready evidential matter exists to support all transactions and adjustments, and that documentation can be promptly provided to auditors upon request; and
- a statement that sufficient knowledgeable staff are available to provide complete and timely explanations of systems and processes to auditors and to fully answer any questions from auditors.

¹ The schedules attached to the memorandum may be revised based on the required mid-range plans due from DoD Components on October 31, 2003, and as DoD managers continue to assess audit readiness.

² Assertions are representations made by management that can be classified according to the following broad categories: (i) existence or occurrence; (ii) completeness; (iii) rights and obligations; (iv) valuation or allocation; and (v) presentation and disclosure. See American Institute of Certified Public Accountants Codification of Statements on Auditing Standards section 326 (AU §326) for details of management assertions.

Explanation of Corrective Actions. The explanation of corrective actions should include enough detail to satisfy the OIG DoD auditors that: (i) corrective actions have been taken to fix the major problems management is aware of and (ii) all related audit recommendations by the OIG DoD, Service audit agencies, or IPAs are closed. Also, the explanation of corrective actions must clearly demonstrate that the affected financial statement or line item is presented fairly and in accordance with generally accepted accounting principles. The explanation must address whether systems that report data have controls in place to ensure the accuracy of the data that is included in the financial statements.

Sufficient Audit-Ready Evidential Matter. The client should state that sufficient audit-ready evidential matter exists to support all transactions and adjustments and that the documentation can be promptly provided to auditors upon request. Specific evidential matter varies depending on the service, fund, financial statement, and line item. The client is responsible for ensuring that the proper evidential matter is readily available to support the balances on the financial statement or line item they represent is ready for audit. The existence of audit-ready evidential matter will be verified during the independent assessment.

Sufficient Knowledgeable Staff. The assertion should state that sufficient knowledgeable staff is available to provide complete and timely explanations of systems and processes to auditors and to fully answer any questions from auditors (experience has shown that clients may need to provide as many as four staff for each auditor in order to provide adequate support). It is imperative that clients understand the resources required to support an audit.

When the OIG DoD auditors receive management assertions that a line item or a financial statement is ready for audit and auditors are satisfied that the explanation of actions taken by management will fix the problems cited, the OIG DoD or an IPA will perform an independent assessment of the line item or financial statement. The assessment shall be sufficient enough to determine whether the corrective actions fix the known problems and whether the affected financial statement or line item appears to be ready for audit. The independent assessment shall also verify the existence of audit-ready evidential matter.

The independent assessment is substantially less in scope than an audit and will not provide assurance that the financial statement or line item is fairly presented in accordance with generally accepted accounting principles. The purpose of an independent assessment is to verify that the corrective actions have been made, the client has audit-ready evidential matter, and that the financial statement or line item appears to be ready for an audit conducted in accordance with generally accepted government auditing standards. If the results of the assessment show an area does not appear to be ready for audit, the auditors will identify specific deficiencies and provide recommendations as appropriate. When the auditors determine that the financial statement or line item appears to be ready for audit, an IPA will perform the financial statement audit in accordance with generally accepted government auditing standards.

The OIG DoD auditors will work with the client to determine the level of effort needed to perform the audit. For assessment and/or audit work that is contracted out to an IPA firm, OIG DoD audit staff will be responsible for writing the statement of work to be contracted out. OIG DoD audit staff will provide oversight (contracting officer representative duties) for assessment and audit work contracted out to IPA firms. Explanations on funding and contracting procedures will be provided as information is finalized through OIG DoD and USD(C)/CFO management.

If you have any questions, please contact Mr. Marvin L. Peek (703-604-9587) or the established OIG DoD point of contact for your Component.



Paul J. Granetto
Director
Defense Financial Auditing
Service