Practice Makes Perfect: Using “Table-Top” Exercises to Simulate the Audit and Help Achieve Audit Readiness for Personnel Payroll Costs

The adage “practice makes perfect” is analogous to the challenge faced by the Department of Defense (DoD) in striving for financial statement audit readiness. This concept is an integral part of the culture and operational fiber of DoD – perhaps more than any other organization in government. The armed forces *train, train, and then train some more* for any and all situations. They understand the rules of engagement and what it takes to be successful. They simulate actual operations, whether it is carrying out a military mission in a war zone, delivering humanitarian aid, extracting a hostage, or targeting a terrorist. Preparation for these types of operations includes:

- Defining the mission – having a clear vision and concept of operations
- Thoroughly understanding the situation and the risks
- Simulating what can happen under a range of conditions and scenarios
- Determining the strategy for overcoming obstacles to achieving the mission
- Developing the operational plans – the tactical solutions
- Practicing, practicing, and then practicing some more to address the range of situations that may occur in the field, so that when the time comes, they are ready to overcome any obstacle.

These same concepts apply to becoming audit-ready. This concept paper, developed by the KPMG Government Institute, focuses on the audit of personnel payroll costs and discusses how a “table-top” operational simulation can support audit readiness in a manner that is efficient and effective.

**Defining the Mission – A Concept of Operations for Auditing Personnel Payroll Costs**

Successfully navigating a financial statement audit begins, long before the auditor arrives. A first-time, full-scope audit can represent a technical challenge, such as having to use legacy systems that may not provide support for the information in the financial statements or may do so in a manner that requires information from multiple data bases that are neither integrated nor designed using common data elements. It can also represent a cultural challenge, given the newness of the process to organizations outside of the comptroller community that may not have experience undergoing a financial statement audit and the nuances and context surrounding such an audit.

In this case, what will be required to pass the test for an audit of personnel payroll costs? Much in contrast to a military mission, where we may not know what our adversary has up its sleeve, there is no mystery here. The auditor’s game plan is readily available. The Government Accountability Office (GAO) and the Inspectors General (IG) have jointly issued the *Financial Audit Manual* (FAM) and the *Financial Information Systems Control Audit Manual* (FISCAM). These manuals, which are publicly available at GAO’s Web site (www.gao.gov) and are very detailed, provide the audit strategy that will be used to perform a federal financial statement audit. These documents provide not only details on what will be covered in the audit, but also needed context.

It is critical to thoroughly understand the contents of the FAM and FISCAM, so that the context of the auditor’s work and expectations for documentation providing evidence supporting a reported balance are clear to you. There are specific sections and tools devoted to personnel payroll costs. Auditors are not seeking *absolute* assurance, but they are seeking *reasonable* assurance that the balances are fairly stated and are not materially misstated. By any measure, DoD’s personnel costs are material to its financial statements. At the same time, the risk of misstatement may not be significant, if there are adequate payroll controls and management can provide documentation requested by the auditor. Even if there are some errors and/or unsupported balances, in the end would these problems result in differences that would constitute a material misstatement in the financial statements?
Thoroughly Understanding the Situation and the Risks

What are the assertions from management that the auditor will be interested in evaluating, as it assesses the reasonableness of the reported payroll costs? What are the risks that may cause the payroll information to be materially misstated and/or not adequately documented for the auditor to become comfortable that management has a handle on the reported balance?

For example, the auditor will be interested in whether pay for a specific position is based on the appropriate pay schedule. Whether the individual is a Colonel or a GS-15, are the rate of pay and the benefits consistent with law and/or regulation and are only current employees being paid? The auditor will be examining systems and internal controls used to make those determinations and will consider what could go wrong and what controls are in place to avoid problems. It will then test controls to determine if they are operating as intended. It will select a sample of transactions to determine whether documentation supports the payment. The auditor will not go back to the beginning of someone’s career to determine if promotions to Colonel or GS-15 were supported. Instead, the focus will be on the evidence that the individual is in fact currently in the position for which he or she is being paid and that the rate of pay and related benefits are consistent with what laws and regulations allow.

By using the FAM and FISCAM as management’s game plan, it will know the height of the bar and what constitute risks to passing the audit test. The questions the auditor will be seeking answers to are spelled out. Think of it as having the exam questions in advance.

Simulating What Can Happen

This is where a simulation, or table-top, exercise comes into play. The personnel and payroll systems include checks and balances—internal controls—because management wants to pay service members and civilian employees properly from the outset. This is a basic management responsibility. How does management know whether it has successfully carried out that responsibility? What are the measures of success? What is the accuracy rate? The answers to these questions should be important to management, regardless of whether there is a financial statement audit.

Keep in mind that a financial statement auditor considers materiality. The bar is set at whether the reported balances are fairly stated—or not materially misstated. So it’s important to test your own controls and assertions by simulating exactly what would happen in an audit. Assessing the entire process will help ensure that key steps are understood, documented, and consistent with laws and regulations governing personnel and payroll, and government accounting standards. You can leverage information already available, such as:

- Periodic internal management assessments that are part of routine internal controls
- Annual reviews mandated by the Federal Managers’ Financial Integrity Act
- Personnel payroll audits performed outside of financial statement audits by the DoD IG, the military service Auditors General, and/or GAO. For example, GAO and the IG reported pay breakdowns related to deployed National Guard and Reserve soldiers.
- Knowledge gained by working day-in, day-out with the personnel and payroll systems.

Perform a table-top exercise to simulate the tests auditors will perform over selected transactions to become comfortable that the controls are effective, and that pay and benefit costs are fairly stated. One way to do this is to take a random sample of personnel and run the supporting documentation through the audit gauntlet. Select different types of scenarios, such as combat pay and leave accounting. Have trained auditors assist in this exercise, working side-by-side with personnel and payroll staff to select the sample, pull the documentation, perform the tests, and interpret the results. In the end, you should have gained a complete understanding of strengths and weaknesses and what is expected to pass an audit. You will thoroughly understand the amount and type of documentation an auditor expects to see.

Working with staff steeped in financial statement audit experience, you can gain a thorough understanding of the significance of problems that may be expected to arise during the audit. For example, if the table-top exercise detects problems in combat pay or leave accounting, would these problems cause an auditor to determine that:

- The reported balance in the financial statements for personnel costs was not fairly stated, or
- It was not possible to tell if the statements were fairly stated, so that the auditor would have to disclaim an opinion on the financial statements.

In other words, what is the exact nature of exceptions identified during the simulation and do they represent errors or documentation problems?

1 The Federal Managers’ Financial Integrity Act, Public Law 97-255, September 8, 1982
Another area the table-top simulation can help is with timing. The auditors have a defined window of time during which to complete the audit, so you need to determine how long it takes to produce the information needed for the audit. The audit clock can simply run out, and it will, if you are not totally prepared. A GAO report on an audit of Army payroll showed that it took three months and repeated attempts to develop a population of active duty Army military members in pay status, and over two months and much labor-intensive research to compare and reconcile the total number of active duty payroll accounts to its database of personnel files. GAO reported that six months after selecting 250 statistical sample items for detailed audit, it received complete documentation for two sample items, partial documentation for three sample items, and no documentation for 245 sample items. This can be a show stopper for an audit of payroll costs.

The table-top exercise will provide a view of how the process works and obstacles that must be overcome for it to work efficiently and effectively to meet tight audit milestones. Time is of the essence. In the first years of audited federal financial statements, agencies had five months under law to prepare audited financial statements; now it is down to 45 days. The table-top exercise can help management determine how long it takes to both obtain adequate supporting documentation and to respond to any auditor questions or requests for additional support. It can also help pinpoint the reasons for any delays, such as weaknesses in the processes for obtaining the information or in the underlying data itself.

**Determining the Strategy for Overcoming Obstacles through Tactical Solutions**

Taking the results of the table-top exercise, management can now focus on reinforcing strengths and addressing weaknesses or obstacles. This is where the strategy and operational planning become important—the tactical solutions. By performing the table-top exercise, you can target solutions because you have simulated the results of internal control transaction testing just as if it were a live audit, without going through the audit. You have tested the operation of the personnel payroll systems and the related internal controls through the eyes of an auditor. You have gained valuable context about what an auditor will be expecting to see, how you can improve the audit trail, and how to address weaknesses that resulted in transactions that would be considered an audit exception. What was missing from the documentation that would trigger an auditor’s taking exception? What error or uncertainty was introduced into the system because controls were either not in place—or not working as intended—that would cause an auditor to question the underlying transactions or whether reporting was complete? What problems were experienced in accessing information or pulling sample items? By answering these questions through a table-top simulation, management can target remedial actions to the issues that will raise concerns for the auditor and avoid unnecessarily impacting audit readiness.

You will also gain an understanding as to how long it takes to complete a given task.

- Why did it take several months to reconcile an account or produce documentation supporting sample items?
- Why was it difficult to locate needed supporting documentation in a timely manner in response to an auditor’s request for additional support integral to the auditor’s transactional testing?
- Why were you unable to quickly respond, when it could result in an inability to audit the account?

As problems arise—and they will in any audit—how will they be addressed so you can be responsive to the auditor’s needs for evidence?

**Practicing, Practicing, and then Practicing Some More**

Once you’ve completed the exercise, you really should go through it again and again. As often as necessary to ensure you have a repeatable process that will pass the audit test. You will continue to learn more each time you do, and see real progress. Similar to a military operation, repeated virtual simulations and constant practice reinforce and refine the process. They enable management to develop a firmer foundation and greater confidence that it can assert auditability and pass the audit test. Walking through the process several times also helps identify necessary adjustments, or if you just need to go back to the drawing board. When the audit occurs, there should be no surprises. Just as on the battlefield—where you cannot take a time-out during combat—the same is true for the audit, if you want to be successful.

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Involving the Range of Stakeholders in the Table-Top Exercise

An audit involves a range of stakeholders in the planning and preparation, and then again in the execution. The table-top exercise should include the same range of stakeholders and—depending on the account to be audited—program and functional managers, who could serve in the principal leadership role. For example, for a table-top exercise of Army personnel payroll costs, stakeholders would include the office of the Assistant Secretary of the Army for Personnel and the Army Human Resources Command. Other stakeholders would include the offices of the Assistant Secretary for Financial Management and Comptroller, the Chief Information Officer, the Under Secretary of Defense (Comptroller), and the Financial Improvement and Audit Readiness directorate.

There should also be early and significant involvement of individuals having extensive experience in auditing financial statements of large, complex federal entities, and preferably with broad knowledge of DoD. This may be in-house staffs, who have been “in the trenches” with federal financial statement audits, or from a public accounting firm with the requisite experience in auditing federal agencies.

Auditor independence is a key component of Generally Accepted Government Auditing Standards (GAGAS), and the federal audit community will rightfully guard against any actual or perceived conflict of interest that could jeopardize their independence in fact or in appearance. Thus, involvement of the military service audit organizations, the DoD Inspector General, and GAO has to be considered in the context of auditor independence, so that auditors are not performing a management function or making a management decision. This does not mean that federal auditors cannot provide technical advice, or serve as a sounding board, or even participate in some table-top tests or exercises as an observer. It does mean that the process will need to be carefully structured to meet the requirements and expectations of GAGAS; there is no margin for error when it comes to auditor independence.

Final Thoughts

The challenge for the personnel and payroll audit cycle is to demonstrate that payroll costs are fairly stated on the financial statements. Simulating audit transaction testing through a table-top exercise to obtain a baseline and to address any shortfalls will provide management the information and understanding needed to navigate the audit process. It is then a matter of “practice, practice, and more practice” so that management has a very high degree of certainty that controls are working as intended and that it can produce supporting documentation needed to pass audit transaction testing. The same approach DoD takes in preparing to successfully carry out its core military missions applies as well to being ready for audit. By simulating the audit through the table-top exercise, you can be fully ready for the day the auditor actually arrives to perform the financial statement audit.

About the KPMG Government Institute

The KPMG Government Institute was established to serve as a strategic resource for government at all levels, and also for higher education and non-profit entities, seeking to achieve high standards of accountability, transparency, and performance. The Institute is a forum for ideas, a place to share leading practices, and a source of thought leadership to help governments address difficult challenges, such as effective performance management, regulatory compliance, and fully leveraging technology.

For more information, visit us at: www.kpmginstitutes.com/government-institute/

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