RESULTS OF THE DEPARTMENT OF DEFENSE'S FISCAL YEAR 1999 FINANCIAL STATEMENTS AUDIT

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM

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CONTENTS

RESULTS OF THE DEPARTMENT OF DEFENSE'S FISCAL YEAR 1999 FINANCIAL STATEMENTS AUDIT

TUESDAY, MAY 9, 2000

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Walden, and Turner.

Staff present: J. Russell George, staff director and chief counsel; Louise DiBenedetto, professional staff member; Bonnie Heald, director of communications; Bryan Sisk, clerk; Trey Henderson, minority counsel; and Jean Gosa, minority assistant clerk.

Mr. HORN. The Subcommittee on Government Management, Information, and Technology will come to order.

The subcommittee recessed after this morning's hearing, and we will proceed today with the results really of the Department of Defense's fiscal year 1999 financial statements audit.

In February, the subcommittee began its third series of hearings to examine the results of financial audits of selected Federal agencies. Since then, we have learned that agencies have made some progress, especially in the area of receiving unqualified audit opinions. However, the important goal of maintaining financial systems that produce accurate, reliable financial information on a day-to-day basis continues to be a significant challenge to nearly all Federal departments and agencies, including the Department of Defense.

Fiscal year 1999 is the 4th year the Department of Defense has prepared agencywide financial statements and the fourth time that the Department's Inspector General could not express an opinion on these statements. The Defense Department's financial information is simply not reliable.

The financial management deficiencies at the Department of Defense continue to represent the single largest obstacle in preventing the U.S. Government from achieving an unqualified opinion on its governmentwide financial statements. As a result, the assets, the liabilities, and net costs of the entire Federal Government continue to be questionable.

Again this year, the Inspector General reported that the Department of Defense cannot accurately report on its finances, including an estimated $196 billion in military retirement health benefits, $80 billion in environmental cleanup liabilities, and $119 billion in general property, plant, and equipment.

The Inspector General also reported that the Department had to process $7.6 trillion in accounting entries to correct errors, add new data and force its financial data to agree with other data sources. At least $2.3 trillion of that money was not supported by documentation.

Last month, the General Accounting Office, Congress's own auditor program fiscal and part of the legislative branch, found that controls over ready-to-fire, hand-held rockets, and missiles at one Army depot in Kentucky were inadequate, leaving these weapons vulnerable to undetected loss, theft, or unauthorized use. The General Accounting Office noted that although these problems were specific to one depot, it could represent a possible systemic weakness throughout the Army.

In addition, auditors found that again in 1999, the Department of Defense was still unable to account for and control more than $1 trillion in physical assets, including ammunition and multimillion dollar weapons systems.

These are just a few of the significant problems identified in the 1999 financial audit. Such lack of accountability, frankly, cannot continue.

The Inspector General, the General Accounting Office, and Defense Department officials acknowledge that the Department's financial management systems are plagued with serious problems, in fact, so serious Department officials feel about this, they do not anticipate having adequate financial systems that can produce reliable information until the year 2003.

Because of the significance of these problems, Department leaders must be committed to addressing both long-term and short-term issues. Today, we want to learn about the Defense Department's incremental improvements to its financial management systems and operations. We also want to explore what is being done to fix its serious, long-term financial problems.

We welcome each of our witnesses and look forward to your testimony. I'd like to especially thank our distinguished guests on panel II for accommodating our invitation on such short notice: Commanding General John G. Coburn, Commander Lester Lyles, and Vice Admiral James F. Amerault. We thank you all.

Just to give you the way we approach this, we do swear in all witnesses, and we don't want you to read your text. We'd just like you to summarize it, because we want to get you out of here on time. I believe General Coburn has to leave, and I think Mr. Lynn has to leave, and we want to get the most out of you while you're here.

Those texts automatically that are written go into the hearing record the minute I welcome you as one of the presenters; and what we prefer, of course, is that summary that you can make. And then we can get into a dialog between those at the table, GAO, and Defense Department as well as those up here in terms of asking various questions for the majority and the minority. Although this is a very bipartisan committee, the questions are probably the same whether it's minority or majority.

So let us start in then with the first presenter, and that is Robert J. Lieberman, the Assistant Inspector General for Auditing of the Department of Defense. Mr. Lieberman.

I should swear you all in. If you've got some staff behind you that will whisper in your ear, get them up, too.

[Witnesses sworn.]

Mr. HORN. The clerk will note that they affirm the oath.

Mr. Lieberman.

STATEMENT OF ROBERT J. LIEBERMAN, ASSISTANT INSPECTOR GENERAL FOR AUDITING, DEPARTMENT OF DEFENSE

Mr. LIEBERMAN. Thank you.

Chairman Horn, Mr. Turner, I appreciate the opportunity to be here today to talk about DOD financial management. The DOD efforts to compile an audit of the fiscal year 1999 financial statements were massive. Nevertheless, the Department could not overcome the impediments caused by poor systems and inadequate documentation of transactions and assets.

In terms of audit opinions, therefore, the results differed little from previous years. A clean opinion was issued by us for the Military Retirement Fund, but the other funds of the Department, including the consolidated statements, were not in condition to merit a favorable audit opinion. So we had to disclaim.

The GAO written testimony elaborates on results of our audits in considerable detail, so I won't repeat the rather lengthy list of deficiencies that precluded favorable audit opinions. Suffice it to say my office issued 36 reports over the last 12 months. I believe one of them was good news. The extent to which DOD must rely on unusual accounting entries to compile financial statements, which has been reported by auditors annually for 10 years but not fully measured until this year, perhaps would be instructive in terms of laying out how far the Department has to go to fix its financial systems. So I'm going to focus on that a bit in this summary.

When the financial reporting system of a public or private sector organization can't produce fully reliable financial statements, accountants sometimes make accounting entries, often as recommended by auditors, to complete or correct the statements. Making major entries or adjustments is not the preferred way of doing business, and there is considerable attention paid to any significant change made to official accounting records.

The notion of accounting records being made on a mass scale to compensate for incomplete and inaccurate financial reporting input is completely foreign to corporate America, as is the prospect of such adjustments being unsupported by clear audit trails. Unfortunately, the audits of the DOD financial statements indicated that at least $7.6 trillion worth of accounting entries were made to compile them. This startling number is perhaps the most graphic imaginable indicator of just how poor the existing automated systems are.

The magnitude of the problem is further demonstrated by the fact that out of $5.8 trillion of these adjustments that we audited this year, $2.3 trillion were unsupported by reliable explanatory information and audit trails. Although there are procedural control issues involved, fundamentally, DOD needs across-the-board automated systems solutions so that it can compile financial statements like any other large business entity would and does.

Unfortunately, developing automated systems on time and with adequate performance has never been the Department's strong suit, and it is still in the process of implementing the Clinger-Cohen Act. We have suggested that, in order to provide additional assurance that the systems development efforts necessary to achieve CFO compliance are successful, the Department adopt the same management approaches that were used for the successful year 2000 conversion.

That's still an ongoing process. Implementation, frankly, has been slower than we would have liked. We intend to continue working closely with the Department to try to put that full process into place. The advantage of that process is, among other things, that it generates measurement information that can be used by the Congress, by senior DOD managers and other interested parties to understand how much progress has actually been made toward the goal.

Right now, we're relying strictly on audit opinions for such information; and using audited opinions as the sole metric is really not satisfactory because a lot of progress can go on and not affect the overall opinion. I give at least one example of that in my statement.

I also stress environmental liabilities in my written statement. There are a couple dozen major categories of deficiencies that we could have selected. I picked that one because it is, first of all, fairly easily understandable; and it also shows you the kinds of issues involved as we try to create Federal accounting standards that make sense for the Federal Government, generate information for financial statements that would be useful to the Congress and the executive branch and, finally, get all the different DOD components who have a share of those liabilities to compute them and report them so that they can be compiled. Each one of these several dozen categories of information that has to be collected is monumental in its own right.

As you mentioned, the Department reported almost $80 billion in environmental liabilities. We feel that's considerably understated. We know that it is understated. These are large numbers. In every case they have to be compiled with the input of hundreds of different program offices and in some cases many dozen automated systems. Meeting that formidable challenge has been a high priority for the Department for 10 years.

As you said, the Department has candidly said that its systems problems will not be solved before 2003; and even that probably is an optimistic estimate, given the fact that most system projects schedules slip both in the public and private sectors.

With that, I'll close and welcome any questions.

Mr. HORN. Thank you very much.

[The prepared statement of Mr. Lieberman follows:]

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May 9, 2000

Statement by

Robert J. Lieberman

Assistant Inspector General for Auditing
Department of Defense

before the

Subcommittee on Government Management, Information and Technology

House Committee on Government Reform

on

Department of Defense Financial Management

May 9, 2000

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity today to provide the views of the Office of the Inspector General on the challenges faced by the Department of Defense in efforts to account for its funds and physical assets, provide useful financial information to decision makers, and operate its huge payroll and contractor payment operations efficiently.

Major DoD Financial Management Issues.

In testimony before this subcommittee almost exactly one year ago, the Deputy Inspector General described the huge scope and unparalleled complexity of DoD finance and accounting operations, as well as the Department's realization during the 1990's that virtually all of its administrative processes were outmoded and unaffordable in their current forms. Likewise, new statutory requirements for audited annual financial statements caught the Department unprepared and without the automated systems needed to compile commercial type accounting data. Along with all other DoD management sectors, the financial management community embarked on a long-term reform effort with particular emphasis on developing a new generation of modern, more standardized and networked systems. Last year we provided our assessment that neither the full integration of DoD support operations, including financial management, nor the achievement of clean audit opinions on the consolidated DoD financial statements were feasible short term goals. We continue to believe, as stated in last year's testimony, that the Department remains a few years away from being able to achieve favorable audit opinions on most major financial statements. The testimony last May covered a number of specific concerns, including:

- The longstanding difficulty in measuring the progress made to improve financial reporting and the danger of focusing on audit opinions on financial statements as the only metric;

- The paramount importance of developing properly integrated, reliable financial information systems;

- Overly complex contracts and accounting requirements.

Today I would like to offer our observations on where each of those matters stands, as the DoD enters its second decade of post-Cold War management reform and restructuring.

Financial Reporting. The DoD efforts to compile and audit the FY 1999 financial statements, for the Department as a whole and for the 10 subsidiary reporting entities like the Army, Navy and Air Force Working Capital Funds, were massive. Nevertheless they could not overcome the impediments caused by poor systems and inadequate documentation of transactions and assets. In terms of opinions, the audit results differed little from the previous year. A clean opinion was again issued for the Military Retirement Fund, but disclaimers were necessary for all other funds, including the DoD-wide consolidated statements.

The General Accounting Office (GAO) written testimony elaborates on the results of our audits in considerable detail, so I will not repeat the rather lengthy list of deficiencies that precluded favorable audit opinions. We agree with GAO's summary of those problems, as well as the overall assessments by both the GAO and the DoD that the Department is making progress toward compliance with the new Federal Accounting Standards.

Audit opinions on the DoD-wide and major fund financial statements still are the sole widely used metric for quantifying progress. Unfortunately, this means that considerable improvement can be made in each of the huge DoD reporting entities without any effect on the overall audit opinions.

For example, the Air Force made a concerted effort to correct records and compile support for transactions so that a favorable audit opinion could be achieved on its Statement of Budgetary Resources (SBR). Notwithstanding these numerous improvements and corrections, the effort could not overcome the problem of an unreliable opening balance. Work continues on the ending balance for FY 1999. Despite a relatively near miss, the Air Force SBR audit result is scored as another failure, a disclaimed audit opinion, but this is only part of the story.

Although the DoD has put considerable effort into improving its financial reporting, it seems that everyone involved--the Congress, the Office of Management and Budget (OMB), the audit community and DoD managers--have been unable to find out or clearly articulate exactly how much progress has been made, what is the planned pace of further action, how much remains to be done and how much risk exists in terms of meeting goals and schedules. Nor has it ever been clear how much the various aspects of this effort have cost to date, how much more will be needed and whether the effort is sufficiently resourced.

Ironically, although the Department annually compiles voluminous documents in response to statutory requirements for multi-year financial management improvement plans and other data, very little of that information is consistently updated, analyzed and used for day to day program management or frequent senior management oversight. Much of it has to be collected in annual data calls to the DoD component organizations. The various reports to OMB and Congress, the annual financial statement audits, and even supplementary audits cannot substitute for structured, readily accessible, meaningful and frequent internal management reporting. Current data on project performance, cost and schedule status should be routinely provided up a clearly defined program management chain and shared with external reviewers.

Currently, a lot of crucial management information exists, but it is dispersed in various organizations and databases. A few years ago, in response to advice from the IG, DoD, the Defense Finance and Accounting Service centralized its management of system acquisition projects into a single program office, which was a significant improvement. That office endeavors to track and coordinate systems development and modification efforts for a couple of hundred systems, most of which it does not own or control. Various other DoD components have organized teams and established internal reporting requirements to track their Chief Financial Officer (CFO) Act compliance progress. The Under Secretary of Defense (Comptroller) has agreed to track the status of various actions that his office, OMB, GAO, and the IG, DoD, have jointly developed and agreed to as part of the effort to address impediments to acceptable financial statements. Also, the IG, DoD, and the Military Departments track the status of management action on all audit recommendations.

In our view, the Department needs to determine how best to collate and share available information, establish any additional metrics needed and require sufficient internal reporting to enable the CFO Act compliance effort to be managed, monitored and controlled as a well integrated program.

In our November 1999 report, "Deficiencies in FY 1998 DoD Financial Statements and Progress Toward Improved Financial Reporting," we recommended that DoD emulate its highly successful "Y2K" management approach to address the challenge of attaining CFO Act compliance. As was the case with the Y2K conversion, the CFO Act challenge has been designated by the Secretary of Defense as a high priority. Similarly, achieving CFO compliance is fundamentally a systems problem, could have goals, criteria and milestones set forth in a clear management plan, involves all DoD organizations and functional communities, and cannot be overcome by the primary functional proponent without the active assistance of the rest of the Department.

Likewise, both efforts have entailed extensive audit verification and testing, and the Congress, OMB and GAO are all strongly interested in measuring progress toward the goal. There would be several advantages to this approach. The Department knows it works, managers are familiar with terminology related to defined phases and system status, and it entails fairly simple and verifiable metrics to show progress and highlight risk areas.

Although the Department reports in its current Financial Management Improvement Plan that the Y2K concept has been adopted, implementation has been disappointingly slow.

The Plan of September 1999 established March 31, 2000, as the milestone for completing the Assessment Phase for CFO Act compliance of 168 critical systems. Despite the Y2K program experience that initial system assessments and status reports often were overly optimistic, incomplete or inconsistent, audit community involvement in validating milestone status has been limited. There has been no feedback on whether this key March 31 milestone was met and what the reported results were.

We plan to work even more closely with the Department over the next several months to apply lessons learned from the Y2K experience to various other DoD-wide information system challenges. In addition to CFO Act compliance, information assurance and oversight of system development projects are areas where we recommend Y2K-like management approaches.

Systems Problems

Over the past year, two issues have underscored the severity of the problems faced by DoD because of inadequate financial systems and the challenges involved in new systems development.

The first issue relates to how DoD financial statements are compiled. When the financial reporting system of a public or private sector organization cannot generate fully reliable financial statements, accountants sometimes make accounting entries, often as recommended by auditors, to complete or correct the statements. Making major entries or adjustments is not the preferred way of doing business and there is considerable attention paid to any significant change made to official accounting records. The notion of accounting entries being made on a mass scale is completely foreign to Corporate America, as is the prospect of such adjustments being unsupported by clear audit trails.

The audits of the 1999 DoD financial statements indicated that $7.6 trillion of accounting entries were made to compile them. This startling number is perhaps the most graphic available indicator of just how poor the existing systems are. The magnitude of the problem is further demonstrated by the fact that, of $5.8 trillion of those adjustments that we audited this year, $2.3 trillion were unsupported by reliable explanatory information and audit trails.

The second issue concerns the management of information system development projects. The Department has been working throughout the 1990's to reduce the number of separate systems and to develop replacements for inadequate legacy systems. Unfortunately, information systems development in the Federal Government is a lengthy proposition. The DoD efforts to develop the next generation of financial systems have had to contend with slowly evolving, but very significant, changes in Federal accounting standards. Also, most DoD modernization and investment programs have faced severe competition for resources. Finally, the Y2K problem may have distracted managers and exacerbated existing resource problems to some extent. Currently, the DoD plans to field all of the systems needed to achieve CFO Act compliance by FY 2003. We regard that as an overly optimistic forecast. Meeting information technology system development schedules is frequently a problem in both the public and private sectors; the DoD is no exception.

The Department's application of Clinger/Cohen Act principles to development of the Defense Joint Accounting System (DJAS) was severely criticized in the House Appropriations Committee Report on the National Defense Appropriations Act for FY 2000. DJAS is one of the four systems chosen to be the next generation of accounting systems replacing numerous legacy systems used by the Army and most Defense agencies. The Committee wrote:

> "Despite the importance of developing joint systems, the Department has allowed the Air Force and the Navy to opt out of this program and to develop and modernize their own distinct systems. Thus, this "joint" system will be fielded only to the Army and a few defense-wide activities. After its initial Milestone 0 approval, the timeline for completing the DJAS software development effort expanded from 16 months to six or more years, the benefits declined from $322,000,000 to $204,000,000 and are now characterized as 'productivity savings', whereas before they were real cost savings. In November,

> the DoD IG issued a draft report warning that DJAS had not completed the steps required under the program management process to be prepared for a Milestone I review. In March, the Office of Program Analysis and Evaluation issued similar warnings about the dramatic change in the programs scope, cost, and duration. Despite these serious concerns, the Department not only issued Milestone I approval, but also Milestone II approval at the same time, all without having a meeting of the IT OIPT to review the system. The Committee rejects this approval as inconsistent with the intent of the Information Technology oversight process and the Clinger-Cohen Act."

We are currently auditing the status of the DJAS project, as requested by the House Appropriations Committee. We have not yet officially reported on the matter, but initial results indicate continued problems complying with Clinger/Cohen Act requirements for careful management oversight when making investment decisions. DJAS life cycle cost would be about $.7 billion. I point to this issue principally to emphasize that more review of the dozens of other systems projects related to

CFO Act compliance is likely to indicate other risks and issues. Implementing the Clinger/Cohen Act is still ongoing in DoD. We are putting high priority, to the extent our constrained audit staffing and budget levels permit, on supporting the Chief Information Officer in his oversight role regarding all information technology projects, including those for financial systems.

Useful Financial Data

In adopting the private sector practice of audited annual financial statements, the Congress clearly expected improved financial management.

The lack of performance metrics and cost data that I previously discussed handicap an assessment of whether the effort to attain auditable financial statements has been worthwhile. The key question to be asked, however, is whether data produced in compliance with Federal Accounting Standards and audited in financial statement audits is useful to users--managers and the Congress. Because much of the data rolled up into annual financial statements is also provided to users in various reports and budget exhibits, often periodically during the year, the focus should be across the spectrum of financial information reported within and by the Department, in whatever form.

Questions on the usefulness of various financial reports can best be answered by the users, not auditors. Unfortunately, we are unaware of much feedback to the DoD CFO community along those lines from other managers or Congress. Hopefully this dialogue will expand in the future, so that the accounting community has the best possible idea of what managers and the Congress actually need, when and in what form.

Financial statement audit results can be very arcane. In my view, some of the asset valuation issues will never have any impact on DoD decision making. However, other management information deficiencies identified during these audits have very practical implications. At last year's hearing, the inaccuracy of DoD inventory data was discussed at length. As noted in our audit reports and the GAO testimony today, inventory accuracy remains a problem. Likewise, the inability to determine actual patient workload and costs in the DoD health care program is still a concern. Today I would like to discuss two other types of data, environmental liabilities and fund status information. In both cases, the data can be used for multiple purposes and the controls over accuracy are important.

Environmental Liabilities

We were unable to verify the $79.7 billion reported for environmental liabilities on the FY 1999 DoD Agency-wide Balance Sheet. The reported amount, as large as it may seem, was clearly understated.

The magnitude of DoD environmental cleanup requirements has been a matter of intense DoD and Congressional interest for many years, but information on costs is fragmented and often unreliable. It would seem logical that costs identified in budget exhibits, other DoD environmental program reports, Selected Acquisition Reports and financial statements should be as consistent as possible, reconcilable and supported. More work is needed to move toward that goal. Specifically, there are unresolved policy issues regarding when to recognize environmental disposal costs for other than nuclear powered weapon systems on financial statements. Also, the support for many of the cost estimates that were included was inadequate.

For example, the $20.7 billion equipment disposal portion of the $79.7 billion overall environmental liability estimate was clearly incomplete, although improved over previous years. The

Air Force reported nothing. The Navy, in contrast, estimated $11.5 billion for nuclear-powered submarine and ship disposal. This was the first time that those amounts were included in the financial statements. An open issue remains on when to recognize disposal costs for most DoD weapon systems on the financial statements--as soon as estimates are made as part of initial weapon system life cycle costing or much later when disposal decisions are made. We are working with the Department and GAO to resolve the question. Regardless of the decision, we have recommended more aggressive action by the Military Departments to ensure that acquisition program managers include hazardous waste handling and disposal costs in the total estimated ownership costs of their systems. Last week we published a report, "Hazardous Material Management for Major Defense Systems," which recaps the results of audits of nine weapon system programs. Those audits indicated commendable emphasis by program managers on reducing the amount of environmentally hazardous material that will require costly disposal, but virtually no emphasis on including disposal costs in life cycle cost estimates.

The DoD reported $34 billion as the liability for environmental cleanup of unexploded ordnance at training ranges. Reporting this amount represents a significant improvement over FY 1998, when cleanup liabilities for training ranges were not recognized or reported at all. However, reporting was incomplete. Although final DoD guidance for reporting liabilities for cleanup of training ranges has not yet been published, it is expected in FY 2000.

The Army, as DoD's Executive Agent managing the Chemical Demilitarization Program, reported about $8.9 billion in environmental liabilities for FY 1999. Further work is needed to validate the support for those estimates, which are particularly important because of the ongoing effort to dispose of the chemical weapons stockpile.

Fund Status Data

The most fundamental budget execution and fund status data maintained by DoD, and relied on by managers at all levels, relates to amounts of authorized funding, obligations, unobligated balances, outlays and unpaid (unliquidated) obligations. Because of the Antideficiency Act, which prescribes criminal penalties for obligations or expenditures in excess of appropriated amounts, and the desire to use all funds efficiently, the primary purpose of DoD financial management information systems over the years has been funds control.

Based on results of audits of obligations and unpaid obligations shown on the Statements of Budgetary Resources in the annual financial statements, we continue to consider funds control a concern. The data for the SBR is drawn from the same sources as data for the monthly SF133 Report on Budget Execution and for the prior year actual column of individual appropriation program and financing schedules, a fundamental budget exhibit.

Audits of FY 1999 financial statements indicated problems with the accuracy and support for reported fund status data.

For example, Air Force auditors projected that $1.3 billion of $36 billion of unpaid obligation balances were invalid. Although this is not a large percentage, and may be adjusted downward as review continues, the Air Force has numerous unfunded requirements and it is cause for concern when over a billion dollars is unavailable for use because of inattention or administrative error. Likewise, in audits of two Defense agencies, we found 70 percent of obligations in one sample and 48 percent in the other to be invalid.

To ensure accurate fund status reporting, DoD must continue efforts to eliminate unmatched disbursements, reemphasize the need for supporting documentation, implement better integrated systems and motivate managers to comply more diligently with DoD policy for periodic review of unpaid obligations. The DoD has reported steady progress in decreasing the level of problem disbursements from $17.3 billion in September 1998 to $10.5 billion in September 1999. These reports are encouraging, but this problem needs to be kept at the forefront of management's attention.

Simplifying Requirements

In the mid-1990's, we recommended that DoD and the Congress consider ways to reduce the burden on DoD accounting offices and the risk of errors by simplifying requirements. The Under Secretaries of Defense (Comptroller) and (Acquisition, Technology and Logistics) have pressed the DoD components to adopt measures to avoid the unnecessary use of multiple accounts on contracts and commingling of funds from different accounts on the same contract line item. Likewise, our office has periodically commented on the incredible complexity of the DoD chart of accounts, which is probably unique in the world because of its hundreds of thousands of accounting entities, and the absurdly long accounting codes that result. Those codes must be applied to many million transactions a year.

Unfortunately, the budget and appropriation structures are difficult to change. The DoD must administer at least 1,200 open appropriation accounts at any given time. The main driver of complexity, however, is the business practice of the individual DoD component. The Army, for example, has resisted simplification of either contracts or its chart of accounts, in effect asserting that it wishes to continue trying to capture costs and control funds at extremely challenging level of detail.

Other Previously Identified Concerns

In last year's testimony we highlighted the Y2K conversion problem, which DoD did a fine job in overcoming. DFAS had a particularly high-profile role in ensuring that military and civilian payrolls would be met. We also expressed concern about information assurance, fraud and limited oversight of finance operations, particularly vendor pay. We continue to view DFAS as a likely target for hackers and are working closely with the Department to reduce vulnerability to computer crime and other fraud. Unfortunately, other priorities and constrained resources minimized our audit coverage of vendor pay over the past year, but we will have new audit results in that area later this year.

Conclusion

Mr. Chairman, every time we testify on DoD financial management, we assert that sustained involvement by senior managers and the Congress are vital ingredients for progress. This remains very much the case. Despite commendable progress, the DoD remains far from CFO Act compliance and aggressive measures will be needed over the next few years to achieve success. Therefore the DoD audit community, which has invested so much effort and resources in this area over the past several years, very much appreciates the Subcommittee's interest in our activities and viewpoints. It may also be useful for me to mention that IG, DoD, audit reports are available on the Web at www.dodig.osd.mil. This concludes my statement.

Mr. HORN. We now have the next presenter from the General Accounting Office, Jeffrey C. Steinhoff, who is Acting Assistant Comptroller General for the Accounting and Information Management Division.

STATEMENT OF JEFFREY C. STEINHOFF, ACTING ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LISA G. JACOBSON, DIRECTOR, DEFENSE AUDITS; AND DAVID R. WARREN, DIRECTOR, DEFENSE MANAGEMENT ISSUES

Mr. STEINHOFF. Mr. Chairman, it's a pleasure to be here today to discuss the state of financial management at DOD. The bottom line, DOD continues to make important progress in addressing its serious financial management weaknesses; and, at the same time, it has a long way to go.

DOD's problems are pervasive, long-standing, deeply rooted, widespread, and complex in nature. What has been markedly different over the past 2 years is that DOD has, for the first time, clearly demonstrated a strong commitment to addressing its serious weaknesses. A number of important initiatives, both short-term and long-term, are under way and planned; and we're seeing positive results, as the IG just mentioned. I applaud Bill Lynn and his team for their efforts.

This commitment, though, must be sustained over a number of years to turn plans into reality. A big challenge remains, and the finish line is not yet in sight. For that matter, it's not even close.

For the short term, continuing efforts to standardize, streamline, and simplify processes—reengineering will be critical to success, as DOD's current processes are extremely convoluted and complex; to strengthen and enforce existing controls; to ensure basic transaction processing which today is a major impediment as the IG pointed out, to enhance human capital; and to oversee performance will be essential.

At the heart of the long-term challenge, and this is a major challenge, is a financial system that is far from compliant with requirements of the Federal Financial Management Improvement Act and needs to be overhauled. The system is not integrated or tied together and really represents a patchwork of systems that individually have weaknesses, some very serious, and collectively just do not get the job done. Information does not automatically flow from system to system, and it really manifests itself as the IG stated, in the $7.6 trillion of adjustments to prepare DOD's fiscal year 1999 financial reports.

And to give you some sense as to the difficulty of the challenge that DOD faces, this is DOD's own depiction over at your right on the poster board, of the current systems environment for its payment system, which as you can readily see, is overly complex. Around the outer edge are 22 payment systems that are fed by numerous other systems, systems that are generally not compatible or properly integrated and often do not use common data codes.

For example, I have an example in my detailed testimony of a 65 character code. It's my understanding that some codes can exceed 100 digits. You make an error on one digit, the transaction gets rejected, it goes into suspense. You have to find it. They are very complex systems. In a nutshell, this tells the story as to what they are trying to fix and this is just one environment. Compounding the challenge is that most of the information needed to prepare annual financial reports and more importantly, I stress more importantly, to manage DOD's resources on a day-to-day basis comes from program or feeder systems—logistics, acquisition personnel—that are not under the direct control of the DOD Comptroller.

He owns about 20 percent of the information. The other managers own the rest. So to achieve the endgame of the CFO Act—and the endgame is beyond financial reporting, it's not a clean audit opinion. It is systems that routinely generate good information for decisionmaking on a day-to-day basis so the gentlemen you'll be hearing on the next package have the data they need to do their jobs well. That's the endgame here. To achieve that endgame, DOD faces a system challenge that far transcends the operation of the Comptroller. I agree fully with the IG and support the efforts by DOD to use the Y2K process as a mechanism for addressing this.

There are great lessons learned by DOD. They had had a success.

I want to just focus on a couple of elements that I think are particularly important though. One, DOD recognized in Y2K that this was not just a CIO issue. This was a chief executive officer issue and the Deputy Secretary took direct control. Once that occurred, you saw a major change. You saw them moving there from the back of the pack up through till they had ultimate success.

The issue with financial management as well as Y2K transcends the operations of DOD and the same type of high-level focus is needed. Several weeks ago, we issued this Executive Guide: Creating Value Through World-class Financial Management. And there are a lot of lessons learned here. This is what successful organizations do. This is how they have success. Organizations like Boeing, Chase Manhattan, GE, Hewlett-Packard, Owens Corning, and Pfizer. They determined that financial management is an entity-wide priority for which the chief executive provides clear, strong leadership including involvement in systems.

Second, Y2K had a date certain. It also had interim milestone dates which were tracked and reported on. The same can be applied here. A clear plan with an end date and enforced interim milestones will be essential.

Third, as the IG representative, Bob Lieberman stated, DOD must follow a standard discipline approach. It will be imperative that there be no shortcuts taken, that Clinger-Cohen be followed.

Systems development has been a high risk area in DOD on GAO's list since 1995. Their last big effort, the corporate information management initiative, went on for about a decade and did not succeed; so it is very important that this project be very closely monitored.

And finally, for Y2K there was extensive validation and verification by the IG as well as end-to-end testing. It just can't be in the environment of preparing financial reports. This all has to be addressed in the environment of having management information for DOD.

In closing, a sustained high level commitment that transcends this administration will be key to the ultimate success of DOD's reform efforts. Likewise, sustained congressional attention such as this hearing and the light you've placed on this issue over the past 5 years will be critical to really instilling the expected accountability in DOD.

Mr. Chairman, this concludes my remarks. I'd be pleased to answer any questions that you or Mr. Turner may have.

Mr. HORN. Thank you very much.

[The prepared statement of Mr. Steinhoff follows:]

United States General Accounting Office

GAO

Testimony

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DEPARTMENT OF DEFENSE

Progress in Financial Management Reform

Statement of Jeffrey C. Steinhoff
Acting Assistant Comptroller General
Accounting and Information Management Division

GAO/T-AIMD/NSIAD-00-163

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss the status of financial management at the Department of Defense (DOD). This is the third year that we have participated in such a hearing before this Subcommittee, and we believe that your sustained commitment to financial management reform governmentwide and at DOD, in particular, has resulted in the steady improvement we have seen across government. At the same time, as we testified[1] before the Subcommittee on March 31, 2000, on the results of our review of the fiscal year *1999 Financial Report of the U.S. Government*, significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal controls, including computer controls, continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs. Material financial management deficiencies identified at DOD, taken together, continue to represent the single largest obstacle that must be effectively addressed to achieve an unqualified opinion on the U.S. government's consolidated financial statements. DOD's vast operations—with an estimated $1 trillion in assets, nearly $1 trillion in reported liabilities and a reported net cost of operations of $378 billion in fiscal year 1999—have a tremendous impact on the government's consolidated reporting.

To date, no major part of DOD has yet been able to pass the test of an independent audit; auditors consistently have issued disclaimers of opinion because of pervasive weaknesses in DOD's financial management systems, operations, and controls. Such problems led us in 1995 to put DOD financial management on our list of high-risk areas vulnerable to waste, fraud, abuse, and mismanagement, a designation that continued in last year's update.[2] Lacking such key controls and information not only hampers the department's ability to produce timely and accurate financial information, but also significantly impairs efforts to improve the economy and efficiency of its operations. Ineffective asset accountability and control adversely affect DOD's visibility over weapon systems and inventory, and unreliable cost and budget information affects DOD's ability to effectively measure performance, reduce costs, and maintain adequate funds control. We have worked closely and constructively with

[1] *Auditing the Nation's Finances: Fiscal Year 1999 Results Continue to Highlight Major Issues Needing Resolution* (GAO/T-AIMD-00-137, Mar. 31, 2000).

[2] *High-Risk Series: An Overview* (GAO/HR-95-1, Feb. 1995), *High-Risk Series: Defense Financial Management* (GAO/HR-97-3, Feb. 1997), and *Major Management Challenges and Program Risks: A Governmentwide Perspective* (GAO/OCG-99-1, Jan. 1999).

the DOD Inspector General (IG) and the military service audit agencies to help provide further clarification of the scope and magnitude of the department's problems and recommendations to correct them.

DOD has made genuine progress in many areas throughout the department, both larger steps forward and smaller incremental improvements. We have seen a strong commitment by the DOD Comptroller and his counterparts in the military services to addressing long-standing, deeply rooted problems. For example, significant areas of improvement include (1) increased accountability over property, plant, and equipment, (2) more complete reporting of environmental and disposal liabilities, (3) increased understanding and documentation of the Fund Balance With Treasury reconciliation process, and (4) development of a detailed concept of operations included in the department's *Financial Management Improvement Plan*. At the same time, DOD has a long way to go. Major problems remain—problems that are pervasive, deeply rooted, and complex in nature. My testimony today outlines DOD's most difficult financial management challenges and describes the initiatives that are in place or planned to address many of them. These challenges include DOD's inability to

- properly account for and report (1) billions of dollars of inventory and property, plant, and equipment and (2) national defense assets, primarily weapon systems and support equipment;
- estimate and report material amounts of environmental and disposal liabilities and their related costs;
- determine the liability associated with post-retirement health benefits for military employees;
- accurately report the net costs of its operations and produce accurate budget data; and
- provide adequate controls over sensitive computer information.

DOD has hundreds of initiatives under way to address these key challenges, with many of the planned fixes designed to result in a one-time, year-end number for financial statement purposes. However, achieving an unqualified or "clean" financial audit opinion, while an important milestone, is not the final goal and must be accomplished through real improvements in the underlying financial management systems and operations that affect DOD's ability to manage its day-to-day activities effectively. The substantial efforts needed to work around DOD's serious systems and control weaknesses to derive year-end balances will not produce the timely and reliable financial and performance information DOD needs to manage its operations every day.

To achieve what the Comptroller General has referred to as the "end game"—systems and processes that routinely generate good financial information for management purposes—will require a major systems and reengineering effort. In this regard, the lessons learned from DOD's Year 2000 experience can prove to be a valuable teacher. Specifically, the successful Year 2000 effort demonstrated that DOD can resolve complex, entitywide problems through top management leadership working across functional lines. Similarly, our *Executive Guide: Creating Value Through World-class Financial Management*[3] notes that building a sound financial management organization begins with leadership that clearly defines and communicates the organization's mission and vision for the future. Finally, I will discuss actions DOD is taking to address training its personnel and the importance of having a strong human capital investment strategy.

Control and Accountability Over Assets Impaired

As discussed in our recent report on the fiscal year 1999 consolidated financial statements, the federal government—one of the world's largest holders of physical assets—does not have accurate information about the amount of assets held to support its domestic and global operations. Material weaknesses in DOD's ability to carry out its stewardship responsibilities over an estimated $1 trillion in physical assets—ranging from enormous inventories of ammunition, stockpile materials, and other military items to buildings and facilities to multimillion dollar weapons systems—were a major factor in the federal government's inability to account for and report on its assets. The following sections discuss DOD's problems and ongoing improvement efforts in accounting for inventory and related property; property, plant, and equipment; and national defense assets.

Accountability Over Inventory and Related Property Remains a Concern

DOD inventory includes ammunition (such as machine gun cartridges, mines, and grenades), repairable items (such as navigational computers, landing gear, and hydraulic pumps), consumables (such as clothing, bolts, and medical supplies), and national defense stockpile materials (such as industrial diamonds, rubber, and beryllium). In its fiscal year 1999 financial statements, DOD reported $128 billion in inventory and related property. The sheer volume of DOD's on-hand inventories impedes the department's efforts to accumulate and report accurate inventory data. We

[3]GAO/AIMD-00-134, Apr. 2000.

reported[4] in our January 1999 high-risk report on defense inventory management that the department needs to avoid burdening its supply system with large unneeded inventories. For example, our analysis of DOD data as of September 30, 1999, showed that 58 percent of on-hand items, or an estimated $36.9 billion of DOD's reported secondary inventory, exceeded requirements.

DOD's inability to account for and control its huge investment in inventories effectively has been an area of major concern for many years. Audit results for fiscal year 1999 again demonstrate that DOD does not know the actual amount and value of inventory for which it is responsible due to three critical deficiencies: (1) physical controls over inventory are inadequate, (2) DOD does not capture all inventories in its records, and (3) reported inventory values are questionable. DOD recognizes the seriousness of this problem and has a number of initiatives under way to address these issues, as well as several broad initiatives intended to simplify the complicated processes it currently uses to account for inventory.

Physical Controls Over Inventory

We, the DOD Inspector General, and the audit services have repeatedly reported on weak controls over DOD supply inventory. The Defense Logistics Agency's (DLA) distribution depots store approximately 75 percent of DOD's consumable and repairable items. DLA is responsible for conducting physical counts of inventory in its depots and measuring and ensuring inventory record accuracy. In June 1999, we reported on significant control weaknesses in DLA's inventory count process that affected the integrity of the physical counts and the reliability of the reported inventory record accuracy.[5] Specifically, 14 DLA distribution depots we visited had reported accuracy rates below DLA's goal of 95 percent and error rates of up to 28 percent, with only 2 depots having accuracy rates above 90 percent. Similar weaknesses continue. During the fourth quarter of fiscal year 1999, only two of DLA's 20 distribution depots reported accuracy rates above 90 percent, and overall accuracy was reported at 83 percent, with error rates ranging from 6 percent to 28 percent.

DLA has a number of initiatives under way to address the inventory accuracy issue. For example, during 1999, DLA initiated the development of a statistical sampling plan to measure the dollar accuracy of DLA-

[4] *Major Management Challenges and Program Risks: Department of Defense* (GAO/OCG-99-4, Jan. 1999).

[5] *Financial Management: Better Controls Essential to Improve the Reliability of DOD's Depot Inventory Records* (GAO/AIMD-99-132, June 28, 1999).

owned inventory. DLA is working with us and the DOD audit community in the design, implementation, and execution of the plan. After refining the plan to address any problems encountered in applying this approach to valuing DLA inventories, DOD plans to expand the statistical sampling plan to include the valuation of the assets it stores for the military services. Further, section 347 of the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 requires the secretary of each military department to set up a schedule to implement best commercial inventory practices for secondary supply items by 2003. The statute defines commercial best practices as including those that will enable the military departments to reduce inventory levels while improving responsiveness to user needs. While not specifically initiated to address this new requirement, DLA's recent contract with the University of Arkansas to examine private sector business practices, including obtaining data on performing and controlling physical counts, should help the department identify and implement commercial best practices in this area.

Physical control weaknesses have also been reported for military service locations that hold inventory. For example, for fiscal years 1997 and 1998, Navy auditors reported 23 percent and 14 percent error rates, respectively, for the Supply Fund storage locations they visited. Because of these poor results and acknowledgment by Navy management that better results could not be expected for fiscal year 1999, Navy auditors limited their tests for the fiscal year 1999 audit. The Naval Audit Service performed limited physical inventory counts at nine selected non-Supply Fund locations to determine if internal controls were in place and functioning well enough to be relied upon to provide accurate and complete inventory records. Results at seven of the nine locations visited indicated that controls were not in place or were not functioning as designed. For example, three of the locations visited had error rates in excess of 10 percent.

Control weaknesses over inventory can lead to inaccurate reported balances, which could affect supply responsiveness and purchase decisions, and result in a loss of accountability. For example, during a December 1999 visit to one Army ammunition depot, we found weak internal controls over self-contained, ready-to-fire, handheld rockets, a sensitive item requiring strict controls and serial number accountability. As detailed in our recently issued report,[6] we and depot personnel identified 835 quantity and location discrepancies associated with 3,272 rocket and launcher units contained in two storage igloos. The depot had more items on hand than shown in its records because of control

[6] *DOD Inventory: Weaknesses in Controls Over Category I Rockets* (GAO/AIMD-00-62R, Apr. 13, 2000).

weaknesses over receipt of items, and, in some cases, the records had location errors. Depot management responded immediately to our findings, and the depot subsequently accounted for and corrected the inventory records of all the rocket and launcher units. Regarding this problem, we identified potentially systemic weaknesses in controls and lack of compliance with federal accounting standards and inventory system requirements and made recommendations to the Army to establish and verify operating procedures to help ensure that systemic weaknesses are corrected.

Inventory Visibility

Over the years, we have reported billions of dollars of materials that were not "visible" to managers—that is, they were not captured in DOD's central visibility records and therefore managers did not know they existed and could not ensure accountability. These kinds of omissions adversely affected the department's financial reporting and its reporting to the Congress on inventory reductions. Further, the lack of complete visibility over inventories increases the risk that responsible inventory item managers may request funds to obtain additional, unnecessary items that may be on-hand but not reported. Recent audit results indicate that these problems continue. Examples of these visibility issues include the following.

- In recent years, we and the audit services have reported weak controls over inventory in transit. For example, the Air Force Audit Agency (AFAA) reported[7] in 1998 that the Air Force did not accurately account for inventory items being shipped from one location to another and did not know the value of this inventory. In addition, the Army Audit Agency reported[8] for fiscal year 1999 that the Army could not determine the value of in-transit inventory and that audit trails did not exist. We reported[9] in 1999 that the Navy had not followed established internal control procedures to notify inventory mangers of inventory shipments or receipts and instead had reported these items as lost during shipment. As a result, the Navy lost visibility of $3 billion of in-transit inventory over the past 3 years. In our February 2000 follow-up report, we reported[10] that the

[7] *Compliance with Federal Financial Accounting Standards Numbers 1 and 3* (AFAA Project 97068017, Sept. 15, 1998).

[8] *Army Working Capital Fund Principal Financial Statements for Fiscal Year 1999: Auditors Report* (Army Audit Agency Report No. AA-00-177, Feb. 10, 2000).

[9] *Defense Inventory: Navy's Procedures for Controlling In-Transit Items Are Not Being Followed* (GAO/NSIAD-99-61, Mar. 31, 1999).

[10] *Department of the Navy: Breakdown of In-Transit Inventory Process Leaves It Vulnerable to Fraud* (GAO/OSI/NSIAD-00-61, Feb. 2, 2000).

majority of the items that the Navy reported as lost were delivered and that there was no evidence of theft in the shipments we reviewed. However, we also found that the inventory process was vulnerable and that Navy may have made procurements during this period for some of these items on hand but not visible to item managers. For example, a commercial repair facility in Singapore received 3 shipments of 67 generators (valued at $593,620) for Navy aircraft that were written off in fiscal year 1997 as an in-transit loss. In October 1999, the Navy purchased 88 generators (valued at $1.2 million) and initiated purchase orders for an additional 145 generators (valued at $1.9 million) Among other items not visible to inventory managers were classified and sensitive items, such as aircraft guided-missile launchers, and unclassified items, such as cockpit video recorders.

On September 14, 1999, the department submitted a plan to the Congress containing 18 proposed actions, performance measures, and implementation schedules. DOD's overall objective is to achieve 100 percent visibility of inventory in transit at all times. As discussed in our February 2000 report on the results of our analysis of DOD's plan,[11] DOD's proposed actions in this area represent a necessary first step to improvement, but the plan does not adequately address how the department will overcome underlying weaknesses that have led to the lack of control over inventory shipments. In any case, the department's efforts to implement the plan are ongoing and are expected to take several years to complete.

- The Naval Audit Service reported[12] that the Navy did not include material turned into stores in its fiscal 1999 financial statements because the inventory was not processed promptly and therefore had not been recorded in the inventory system. At one distribution depot, the Navy had a backlog of materials turned into that depot of an estimated 122,000 line items as of September 30, 1999. This represented a backlog of approximately 10 months, according to the Deputy Commander of the depot. These items were not recorded in any inventory record and were therefore not visible to the item managers for management and planning. This backlog could result in the Navy purchasing items that it does not need because item managers do not have information on all items that are already on hand.

[11] *Defense Inventory: Plan to Improve Management of Shipped Inventory Should Be Strengthened* (GAO/NSIAD-00-39, Feb. 22, 2000).

[12] *Fiscal Year 1999 Consolidated Financial Statements of the Department of the Navy Working Capital Fund* (Naval Audit Service Report No. N2000-0019, Feb. 14, 2000).

- In its fiscal year 1999 financial reporting, the Navy included for the first time, several key categories of inventory, such as sponsor-owned material[13] valued at $5.5 billion and inventory items at redistribution sites valued at $600 million. At the same time, deficient logistics systems continue to impair the Navy's ability both to maintain visibility and prepare reliable financial reports for these assets effectively. For example, one command could only estimate a value for its sponsor-owned inventory because it did not have a system in place to capture and report this material. The command's estimate of $2 billion represented over a third of the Navy's reported $5.5 billion of sponsor-owned material. Further, while the Navy's inclusion of several key inventory categories has substantially improved the completeness of its inventory reporting, not all categories of Navy inventory are yet included. Specifically, Navy auditors reported in February 2000[14] that the Navy's fiscal year 1999 reporting omitted $9.2 billion of shipboard inventories because logistical systems could not fully support the required accounting methodology. Lacking effective financial management systems that can provide the information needed to produce financial reports, various Navy commands rely on data calls and error-prone manual reentry of inventory data. For example, one Navy command did not report any inventory. However, after a follow-up review by Navy auditors, the command reported inventory of $550 million. During fiscal year 1999, the Navy began an effort to identify and evaluate the logistics systems used to account for and control its inventories. The Navy established a working group of senior Navy financial and program managers and audit community representatives to address this issue. To start, the working group is focused on evaluating existing systems to identify opportunities to consolidate and substantially reduce the number of systems. In the next phase, the group is to work on improving the asset visibility and financial reporting capabilities of the remaining systems.

- Air Force auditors could not verify the accuracy of $2.9 billion in inventory in the hands of contractors.[15] The Air Force extracted that amount from the Contract Property Management System for financial reporting. However, the auditors could not determine whether the $2.9 billion of inventory shown in the system was reliable because the system did not provide a sufficient audit trail.

[13] The Navy defines sponsor-owned materials as items outside of the supply fund that support weapon systems and equipment.

[14] *Fiscal Year 1999 Department of the Navy Principal Statements for Fiscal Year 1999* (Naval Audit Service Report No. N2000-0018, Feb. 10, 2000).

[15] *Opinion on Fiscal Year 1999 Air Force Consolidated Financial Statements* (Air Force Audit Agency Report No. 9953002, Feb. 9, 2000).

DOD is making efforts to improve its inventory management and ability to report reliable inventory levels to the Congress and in financial statements. DOD's Total Asset Visibility initiative is designed among other things to, link inventory information systems to improve asset visibility and provide the capability for inventory redistribution among DOD components. Our recent work has shown that DOD has made limited progress in achieving departmentwide asset visibility. Specifically, we reported the Department's implementation plan for its Total Asset Visibility initiative did not address DOD-wide problems with systems critical to the initiative's successful implementation.[16] The Secretary of Defense's 2000 *Annual Report to the President and the Congress* incorporated a Total Asset Visibility goal of 90 percent. The longer term Total Asset Visibility goal is 100 percent visibility by 2004.

Inventory Valuation

DOD has long-standing problems accumulating and reporting the full costs associated with working capital fund operations that provide goods and services in support of the military services, its primary customers. The foundation for achieving the goals of these business-type funds is accurate cost data, which are critical for management to operate efficiently, measure performance, and maintain national defense readiness.

Federal accounting standards require inventories to be valued based on historical costs or a method that approximates historical costs. Valuation is of particular importance to capture the cost of operations in DOD working capital funds, which in turn is critical to the usefulness of related performance measures. DOD working capital funds charge their customers for the support operations provided, including administrative and overhead costs. Every dollar that the military services spend inefficiently on DOD working capital fund purchases results in fewer resources available for other defense spending priorities. Simply stated, working capital fund overcharges could result in the military services using more Operations and Maintenance appropriations in the current year than anticipated; undercharges could result in unanticipated future pricing increases and additional funding requests.

DOD systems do not capture the information needed to report historical cost. Instead, inventory records and accounting transactions are maintained at a latest acquisition cost or a standard selling price. Because systems do not capture historical costs, DOD working capital funds have attempted to estimate historical cost through the use of a spreadsheet

[16] *Defense Inventory: DOD Could Improve Total Asset Visibility Initiative With Results Act Framework* (GAO/NSIAD-99-40, Apr. 18, 1999).

application. This methodology takes general ledger data at standard price values or latest acquisition values and revalues the general ledger data to estimated historical costs. This methodology is dependent, therefore, on accurate general ledger data. Auditors have previously reported that the logistical systems and general ledger systems are not integrated. As a result, large adjustments are necessary to bring general ledger records into agreement with logistical records. For example, for fiscal year 1999, the Navy recorded $1.5 billion, the Army recorded $3.8 billion, and the Air Force recorded $15.5 billion in adjustments to bring general ledger records into agreement with logistical records. To illustrate the magnitude of these adjustments, the Air Force Supply Fund revenue for the year was only $10.2 billion.

Further, the Naval Audit Service reported[17] that an error in the valuation methodology in 1998 resulted in overstating the cost of goods sold by $1.2 billion. The Navy was unable to correct this error in applying the methodology in 1999. Moreover, even if general ledger data are accurate, the valuation methodology may lack the necessary precision to produce a reliable estimate of cost of goods sold. For example, the Navy methodology revalued inventory from $34 billion (selling price) to $16 billion (historical cost estimate). A 5-percent error in this estimate would result in a misstatement of $900 million in the Navy's Supply Fund reported net operating loss of $976 million and reported inventory of $15.8 billion for fiscal year 1999.

Army auditors reported[18] for fiscal year 1998 that they were unable to audit the Army's application of the methodology because there was insufficient documentation to support the calculation. Further, Army auditors reported that inventory balances at year-end improperly included inventory losses of $5.1 billion and inventory gains of $4.5 billion. Such gains and losses should be recognized in the net cost of operations in the period in which they occurred. In fiscal year 1999, Army auditors reported[19] that these problems continued to exist and that removing these period costs are necessary before an accurate estimate of historical cost can be developed.

[17] *Department of the Navy Working Capital Fund, Inventory Records and Valuation* (Naval Audit Service Report No. N2000-0014, Dec. 30, 1999).

[18] *Army Working Capital Fund FY 98 Financial Statements, Inventory Allowance Accounts* (Army Audit Agency Report No. AA 00-63, Nov. 17, 1999).

[19] *Army Working Capital Fund, Principal Financial Statements for Fiscal Year 1999* (Army Audit Agency Report No. AA 00-177, Feb. 10, 2000).

Further complicating the inventory valuation issue, inventory levels reported to the Congress are reported at latest acquisition cost. Although latest acquisition cost data may be important for budget projection and purchase decisions, this information may not be appropriate for performance measurement. Latest acquisition cost can substantially differ from the cost paid for the item. To illustrate how this occurs, assume a military service had 10 items that cost $10 each, so each item would be valued at $10, or at $100 in total. However, if the service then purchased 1 new item at $25, all 11 items would be valued based upon the latest purchase price of $25, or $275 in total. The Commander of Air Force Materiel Command recently testified that such valuation practices distort DOD's progress toward reducing inventory levels. The Commander stated the following.

> "Each year, inventories of old spare parts were increased in value to reflect their latest acquisition price (the normal commercial practice is to deflate, not inflate, the value of long term assets). Many supply managers who faithfully disposed of unneeded inventory were surprised at the end of the year to see their total inventory value increase. As a result, they were subject to great pressure to further reduce inventory levels. . . .The new spares were needed but funding restrictions prevented purchase of these parts for several years."[20]

Overall, the effect of increasing prices can be demonstrated by noting that the Air Force's $32.6 billion of inventory at latest acquisition cost is revalued to $18.3 billion to reflect estimated historical costs.

Accurate inventory cost data are also important to measuring operational performance. A key performance measure is net operating results, the difference between revenue and expenses related to that revenue. Net operating results are an important factor in setting prices charged to customers. Navy management has acknowledged that due to unreliable inventory cost data, the reported net operating results for the supply fund are unreliable and cannot be used in the price-setting process. Several initiatives are ongoing to address inventory valuation issues, as noted in the following section.

Broad Simplification Initiatives

In addition to the specific initiatives discussed previously, DOD has a number of broad-based initiatives that are intended to simplify its

[20] Statement of General George T. Babbitt, USAF, Commander, Air Force Materiel Command, Before the Subcommittee on Military Readiness, Committee on Armed Services, House of Representatives, October 7, 1999.

complicated processes for accounting for inventory. Initiatives such as these, if effectively implemented, could help achieve the kind of wide-ranging process changes throughout the department that will result in long-term improvements in this area.

- The Air Force has begun an initiative to revise current inventory systems to capture historical costs. Senior Air Force financial management officials believe that historical cost data by inventory item provide the best information by which to manage the supply fund business. A working group of Navy senior financial and logistical managers is also considering the benefits of moving to a historical cost system.
- One impediment to valuing inventory at historical cost is establishing a beginning value for DOD inventory. Much of DOD inventory has been on hand for many years, and supporting documents may not be available within DOD systems. We are currently working with DOD officials to evaluate procurement data available within DOD and other sources to address this issue.
- The Air Force is considering the adoption of private sector practices to account for repairables, which represent the majority of supply fund inventory. The Air Force had a contractor review DOD inventory accounting and valuation processes versus those of the private sector. The contractor concluded that adoption of private sector practices, including the use of historical cost, would simplify accounting transactions. For example, under DOD's current accounting procedures, logistical actions, such as transfers of inventory between locations, changes in condition code, and turn-in of an asset for repair, result in adjustments to the financial systems. Under private sector practices, the same transactions would be recorded in the logistical systems but not in the financial systems because they have no impact on inventory valuation. The contractor estimated that adoption of such private sector accounting practices would eliminate 155 million general ledger transactions currently processed by the Air Force. This is an estimated 78 percent reduction over current Air Force accounting practices for these types of logistical actions.
- The Army has initiated an effort to consolidate supply fund inventory into a single stock fund. The Single Stock Fund initiative will integrate separately managed wholesale and retail stock fund inventories into a single Army stock fund. By October 2000, stock-funded supplies owned and managed by installations—currently retail stock fund—are expected to become wholesale assets to be managed by the Army Material Command. This initiative is intended to improve the acquisition and distribution of supply items by eliminating numerous inefficiencies, such

as duplicative levels of stock and several automated systems managing the same inventory, and a lack of central item manager visibility over inventory at Army bases and installations. Further, this initiative will eliminate multiple points of sale and credit, billings, and general ledgers, thus reducing the number of accounting transactions. Army financial managers expect significant dollar savings to result from this initiative, although program officials have not yet estimated those savings.

Similarly, in an effort to improve visibility and financial management of inventory, the Navy changed ownership of over $2 billion of shipboard repairables from general fund commands to the supply fund during 1998 and 1999. This change provides central visibility and transaction-based reporting of this inventory.

General PP&E Amounts Are Still Unreliable But Efforts Are Underway to Address Deficiencies

DOD is responsible for almost one-half of the government's reported general property, plant, and equipment (PP&E).[21] For fiscal year 1999, DOD reported a gross value of about $208 billion of general property assets, including $151 billion in real property (land, buildings, facilities, capital leases, and improvements to those assets), $35 billion in personal property (such as computer software, computer mainframes, and equipment), and $22 billion in construction-in-progress. For the past 2 years, we have testified before this Subcommittee concerning Defense financial management and have detailed numerous problems that affected DOD's ability to value and account for real and personal property, including property in the possession of contractors. Unless DOD knows the actual (historical) costs of its facilities and equipment, the department cannot properly depreciate and assign costs to the programs and activities that benefit from use of those assets. Further, until its systems can accurately account for the existence and movement of general property, DOD cannot know the location and condition of those assets or safeguard them from physical deterioration, theft, or loss.

To address accountability and financial reporting issues, DOD has begun several initiatives over the past year. Due to the department's enormous size and complexity, however, most of its PP&E initiatives are still in

[21] Statement of Federal Financial Accounting Standards No. 6 states that general PP&E is any property, plant, and equipment used in providing goods and services. It typically has one or more of the following characteristics: (1) it could be used for alternative purposes (e.g., by other federal programs, state, or local governments, or nongovernmental entities) but is used to produce goods or services, or to support the mission of the entity, (2) it is used in business-type activities, or (3) it is used in activities whose costs can be compared to those of other entities performing similar activities (e.g., federal hospital services in comparison to other hospitals).

process and have not yet fully affected its operations or the reliability of amounts reported.

Real Property

DOD's real property represented more than 70 percent of its reported PP&E for fiscal year 1999. Last year, DOD took a step forward to address one of its long-standing PP&E problems, the valuation of its beginning real property balances. Specifically, the department obtained contractor assistance in validating its recorded real property amounts (or recommending ways to develop auditable values), compiling reported PP&E data, and helping to maintain accurate property records. The contractor sampled and surveyed nearly 1,300 real properties, estimated a current replacement cost for each, deflated that cost back to the property's acquisition date, and compared the deflated replacement cost to the cost recorded in DOD's property database. All major DOD components except for the Corps of Engineers were included in this effort.

The contractor has finished its work and reported the results of its validation effort.[22] Because we and the DOD audit community have not yet completed our reviews of the contractor's work, we cannot address the methodology or conclusions at this time. It is our understanding that the valuation effort has provided results at a DOD and servicewide level (Army, Navy, and Air Force) but not at lower levels that are used for reporting, such as the Army Working Capital Fund or DLA. Therefore, the results may not support determining the cost of many DOD activities or the calculation of user fees and other reimbursable charges.

As agreed, the contractor's valuation effort was limited to real property on DOD's books at September 30, 1998. Therefore, in order to evaluate the reliability of recorded values at September 30, 1999, DOD auditors needed to test real property transactions—additions, deletions, and modifications—that occurred during that fiscal year. Having valuation results as of September 30, 1998, will not be useful to DOD if it cannot maintain a reliable balance going forward. Component audit tests showed that DOD continues to lack the necessary systems and processes to ensure that its real property assets are promptly and properly recorded in real property databases. For example, auditors found the following deficiencies.

- Real property transactions are not promptly recorded. As reported, Army auditors reviewed about $408 million in real property addition, deletion,

[22] *Department of Defense Real Property Validation Phase II, Accuracy Test Results* (PWC Contract No. GS23F-8126H, Delivery Order MDA 210-99-F-001, Task 2.2, Deliverable 2.3, Dec. 9, 1999).

and modification transactions recorded during fiscal year 1999 and determined that $113 million of those transactions should have been posted in prior fiscal years. Army auditors also identified $43 million in unrecorded real property transactions.[23] Air Force auditors identified backlogs of unprocessed real property transactions totaling approximately $781 million at 46 of the 99 locations audited.[24] In addition, Air Force auditors found that real property constructed under multi-facility construction contracts was not always recorded until construction was completed on all facilities under the contract. Navy auditors also found that real property assets were not being recorded when construction was completed. Because Navy activities did not consider contracts complete for purposes of removing assets from construction-in-progress until the final payment was made, auditors found over $55 million of unrecorded new construction or improvement costs at two locations.

Navy auditors also found that Base Realignment and Closure (BRAC) funded property transactions were not always recorded in Navy databases. While costs associated with closing activities should be expensed, some costs incurred to realign activities should be capitalized, such as new construction or major improvements. Navy auditors identified millions of dollars of newly constructed or improved assets paid for by BRAC funds that were not captured in the Navy's accountability and financial reporting databases. For example, the $4.3 million renovation costs associated with a building that the Naval Audit Service moved into in June 1999 and $18.4 million in capital improvements at the Naval Facilities Engineering Command (NAVFAC) headquarters building were not recorded in the Navy's database.

Sufficient controls over processing and reporting real property amounts did not exist. For example, Navy auditors found that reconciliations between accountability and financial reporting systems are not always performed. Navy auditors identified over $10 million in discrepancies between the Navy working capital fund accountability and financial reporting records at one location and noted a more than $13 million difference at another location. Air Force auditors found that acquisition costs reported by the Air Force for fiscal year 1999 were overstated by $3.4 billion due to compilation errors related to the costs of buildings and other structures at 15 installations. In addition, Air Force auditors could

[23] *Army's General Fund Principal Financial Statements for Fiscal Year 1999, Summary Audit Report* (Army Audit Agency Report No. AA 00-168, Feb. 9, 2000).

[24] *Opinion on Fiscal Year 1999 Consolidated Financial Statements* (Air Force Audit Agency Report No. 99053002, Feb. 9, 2000).

not obtain supporting documentation for about $1.8 billion of the Air Force's $2.8 billion of construction-in-progress amounts reported for fiscal year 1999.

DOD must quickly address the problems that the auditors identified during their fiscal year 1999 testing related to backlogs and the proper recording, reconciling, and reporting of new property transactions. Until DOD has the systems and processes in place to maintain accurate, up-to-date property records, any valuation baseline will not be sustainable and accountability for real property will not be ensured.

Personal Property

As discussed in our testimony last year, the most important issue related to personal property is the accuracy of the underlying accountability records. DOD's draft accountability regulations support this position and require that all assets valued at $2,500 or more be in property databases for accountability purposes. Also in line with this, the DOD Comptroller and the military services have redirected their personal property efforts to first ensure the accuracy and sustainability of personal property databases before attempting to address any valuation issues. The audit community and the Office of Management and Budget have agreed to and support this approach as prudent and consistent with the goals of the Chief Financial Officers Act.

DOD and the military services have recognized that major changes, such as implementation of standard automated systems and operating procedures, are necessary to ensure accountability and financial control of personal property. To move toward these goals, the military services general fund activities, which are responsible for most personal property reported by DOD, have begun implementing short-term initiatives over the past year, such as performing or testing personal property inventories, providing training to personnel responsible for maintaining the data, and developing procedures and controls to ensure the reliability of future transaction processing.

For example, the Department of the Navy has been working to ensure the reliability of its personal property records by standardizing its personal property processes and procedures and actively implementing the Defense Property Accountability System (DPAS) at locations worldwide. Over the past year, the Marine Corps has performed and reconciled the results of wall-to-wall physical inventories of assets valued at $2,500 or more and has fully implemented DPAS at 30 sites. The benefits of the wall-to-wall inventories are easily understood when you consider that at one location alone, the number of assets recorded in the accountability database increased by over 35 percent, which added 478 items to the originally reported 1,375 items, while the dollar amount increased by 28 percent, or about $700,000 more than the beginning value of $2.4 million. The Navy's efforts to conduct inventories and implement DPAS at Navy sites are still ongoing.

The Army and Air Force general fund activities are also beginning to focus on accountability. The Army has begun to implement DPAS to report its personal property. However, during fiscal year 1999, it temporarily suspended implementation of DPAS at some of its major installations due to problems encountered in converting logistical data from existing databases. As a result, as it had for fiscal year 1998, the Army relied on data calls to obtain information on equipment balances for financial reporting because it had no central system. Although the percentage of units responding to the Army's data calls increased from 78 percent for fiscal year 1998 to approximately 97 percent for fiscal year 1999, only $857 million was reported for equipment—an over $800 million decrease from the prior year.[25] Army officials were unable to explain this 48 percent decrease. To address these problems, the Army remains committed to DPAS and hopes to complete its implementation at general fund sites by the end of fiscal year 2000. They have also hired a contractor to test the accuracy of the assets reported in DPAS.

Rather than implement DPAS, the Air Force has chosen to modify its three personal property systems, the primary one being the Air Force Equipment Management System (AFEMS), to meet accountability and reporting requirements for assets that individually equal or exceed DOD's financial reporting capitalization threshold of $100,000. Over the past year, the Air Force has added data fields to AFEMS to establish detailed records for these higher valued assets. Also, during fiscal year 1999, Air Force activities verified the existence of assets recorded in AFEMS that were valued at $100,000 or more. Assets in AFEMS that were less than DOD's $100,000 capitalization threshold, but exceeded DOD's $2,500 accountability threshold, were not included in this verification effort. As of March 2000, personal property assets that did not meet DOD's $100,000 financial reporting threshold accounted for over 99 percent of the total number of personal property assets recorded in AFEMS and approximately 45 percent (or $6.4 billion) of the total reported personal property value. Many of these assets are "p[illegible]ed" in AFEMS rather than controlled at a serial number level, which may impede any efforts to ensure that assets below $100,000 are recorded in the database for

[25] *Army's General Fund Principal Financial Statements for Fiscal Year 1999, Summary Audit Report* (Army Audit Agency Report No. AA 00-168, Feb. 9, 2000).

visibility and accountability purposes. Air Force officials have indicated they have initiated a change in their systems and processes to eliminate these pools and provide individual accountability for items over $2,500. In addition, they have hired contractors to validate that the existing assets are properly reflected in AFEMS.

Although issues such as DOD's capitalization threshold, depreciation periods, and systems integration do not affect current personal property efforts as long as those efforts focus on accountability consistent with DOD regulations, they do affect financial control and reporting for both real and personal property. To begin addressing some of these issues, DOD hired contractors to advise the department on appropriate capitalization thresholds and depreciation periods for real and personal property. The contractors have issued their reports concurring with DOD's current $100,000 threshold for financial reporting and depreciation periods, but they noted that the databases they analyzed may not have been appropriate, complete, and accurate. For example, as we previously discussed, the Marine Corps' wall-to-wall inventories have identified significant numbers of assets not included in their personal property databases. In addition, the databases that were analyzed may not have included approximately $20 billion of personal property held by contractors—an amount that was not reported in DOD's financial statements but which represents more than half the gross value for personal property that was reported for fiscal year 1999. The contractors also recommended that if adjustments are made to the underlying databases or if data integrity is improved, DOD should reevaluate the study's results. We have not yet reviewed the contractors' work but we agree that the limitations they cite could directly affect the materiality and appropriateness of the recommended capitalization threshold and the effect of the current depreciation periods. To ensure that the contractors' recommendations are appropriate, DOD needs to evaluate the accuracy of the databases that were used and analyze the full impact of property excluded from the study.

Although each of the services has various short-term initiatives to improve accountability, long-term sustainability and efficiency require systems integration—acquisition and payment systems must be linked with property accountability systems. The Navy, recognizing the usefulness of system interfaces to maintain accountability and financial control, has established a working group with DOD's DPAS office to begin developing electronic interfaces in accordance with the financial management systems requirements of the Federal Financial Management Improvement

Act of 1996.[26] The Army also has efforts under way and systems under development to provide needed interfaces. The Air Force has asked audit personnel to review its property systems under development and ensure that required integration is considered during development. To support these efforts, DOD has established a Property System Implementation Steering Committee, chaired by the Director of Acquisition Resources and Analysis, to emphasize property issues affecting the department and begin addressing those issues.

Problems Persist With Data and Reporting on National Defense Assets

Beginning with fiscal year 1998, DOD was required by federal accounting standards to report its national defense assets[27] in a stewardship report, which is treated as required supplementary information in its financial statements, rather than on its balance sheet. The reported cost of this equipment in fiscal year 1997–the last year for which such information was reported on its balance sheet–was more than $600 billion. In its fiscal year 1999 financial report, DOD did not report on its national defense assets in accordance with accounting standards. Instead of reporting total costs of these assets as required by the standards, DOD reported quantities only for major weapons systems and real property, and yearly disbursements for items bought with procurement funds. This reporting is based in part on proposed amendments to the accounting standards, but the amendments were not passed when voted on in October 1999. In addition, DOD continues to experience problems in accumulating and reporting accurate information on its national defense equipment, as well as foreign sales activity related to these assets. The military services have made some improvements on these issues and are continuing to work toward more reliable logistical data for these assets.

Incomplete Data and Financial Reporting

Information on national defense assets remains a concern because, for fiscal year 1999, (1) it is incomplete and (2) activity during the year is not properly recorded.

The national defense asset quantities reported for fiscal year 1999 are incomplete primarily for two reasons. First, DOD policy instructed the services to report only certain categories of national defense assets and

[26]The Federal Financial Management Improvement Act of 1996 provides a legislative mandate to implement and maintain financial management systems that substantially comply with federal financial management systems requirements, applicable federal accounting standards, and the U.S. *Standard General Ledger*.

[27]National defense assets consist of weapons systems, weapons systems support equipment, mission support equipment, and weapons systems support real property.

specifically excluded two of the major categories—support principal end items,[28] such as aircraft engines and radars, and mission support equipment,[29] such as nontactical vehicles and cryptographic systems. As a result, thousands of different types of support equipment costing billions of dollars were not reported anywhere in DOD's financial report. For example, the Army reported quantities for only 279 types of equipment out of more than 1,600 types. Unreported items include

- Army communication equipment with an estimated value of $5.7 billion,
- Navy aircraft engines with an estimated value of $7.6 billion, and
- over 2,300 Air Force electronics systems pods that attach to aircraft, with costs ranging from over $1 million to $5 million each.

Second, some items may not have been reported because they are not recorded in any centralized asset visibility system. Because the services cannot identify all of their assets through a centralized system, each service had to supplement its automated data with manual procedures to collect the information. For example, the Army again conducted an Army-wide data call as it had in fiscal year 1998 to capture items not reported in its centralized systems. Items identified as a result of this data call that were not included in the Army's centralized systems included 56 airplanes, 32 tanks, and 36 Javelin command-launch units. The Air Force had to use manual procedures to compile its missile data from a number of different systems and to try to avoid double counting and/or omissions. The Navy had to obtain data on ballistic missiles from inventory control personnel who maintain local spreadsheets on the missiles at two Navy facilities. The use of manual procedures, such as data calls, results in less reliable information because it is dependent on individuals responding promptly and accurately. For example, only 78 percent of Army units responded to a data call in time for its fiscal year 1998 reporting. Although this percentage increased to 97 percent for fiscal year 1999, the reliability of the information from the data call was not tested. Furthermore, the necessity for manual procedures prevents DOD from having visibility over all of its assets and the day-to-day information needed to effectively manage its

[28]Support principal end items are items acquired to support weapons systems and may ultimately be incorporated in weapons systems.

[29]Mission support equipment is deployable equipment that (1) is essential to the effective operation of a weapon system or is used by the military services to carry out their military missions, (2) has an indeterminate or unpredictable useful life, and (3) is at very high risk of being destroyed or becoming prematurely obsolete.

operations. For example, DOD's lessons learned studies from Operation Desert Storm highlighted combat support problems associated with tracking the status and location of personnel and supplies. As previously mentioned, DOD has a goal of 100 percent visibility over its assets by 2004.

The services have historically been unable to maintain information on additions and deletions for most of their national defense assets. While some progress has been made toward improving this data, auditors found that much of it was still unreliable for fiscal year 1999. Reliable information on additions and deletions is an important internal control to ensure accountability over assets. Without integrated accounting, acquisition, and logistics systems to provide accounting controls over asset balances, this control is even more important. For example, acquisition personnel should be able to review information on additions to ensure that all assets acquired are reported in logistics systems. If such a control is not in place, DOD cannot have assurance that all items purchased are received and properly recorded.

Further, since October 1998, we have issued four reports identifying internal control weaknesses in DOD's foreign military sales program that includes sales of national defense assets and services to eligible foreign countries. Most recently, on May 3, 2000, we reported[30] that the Air Force did not have adequate controls over its foreign military sales to ensure that foreign customers were properly charged. Specifically, our analysis of data contained in the Defense Finance and Accounting Service's Defense Integrated Financial System as of July 1999, indicated that the Air Force might not have charged FMS customer trust fund accounts for $540 million of delivered goods and services.

In performing a detailed review of $96.5 million of these transactions, we found that the Air Force was able to reconcile about $20.9 million. However, of the remaining $75.6 million, the Air Force had either

- failed to charge customer accounts ($5.1 million, 22 transactions);
- made errors, such as incorrectly estimating delivery prices ($44 million, 11 transactions); or

[30] *Foreign Military Sales: Air Force Controls Over the FMS Program Need Improvement* (GAO/AIMD-00-101, May 3, 2000).

- could not explain differences between the recorded value of delivered goods and services and corresponding value of changes to customer accounts. ($26.5 million or 19 transactions).

Improvement Initiatives

Each military service has taken some actions to improve its national defense asset data. Some of these actions are short-term solutions, while others are intended to provide longer term, permanent improvements in the way the data are maintained. For example, the Navy is currently taking a servicewide inventory of all of its aircraft engines to improve its data for these assets. While this might result in accurate data for a given point in time, longer term—both with respect to the design of the systems and to basic transaction processing—logistics system changes are needed to ensure that the data remain accurate. An ongoing, longer-term improvement effort involves a new working group that is trying to improve ship and boat data. The group is developing new software and has developed new guidance for managing ship and boat information, including guidance for an annual inventory validation and for boat disposals. In another effort intended to improve all of the Navy's national defense asset data, the Navy has hired a contractor to evaluate its systems, methods, processes, and procedures used to account for its national defense assets.

The Army has made several short-term improvements in its national defense asset information and is also developing a long-term solution. Most of the short-term efforts stemmed from lessons learned during the fiscal year 1998 financial reporting process. For example, the Army improved its method for determining which assets should be reported as national defense, and it gained a better understanding of the types of information available in its myriad logistics systems. These lessons learned should help it develop needed systems improvements in the future, including the development of its Logistics Integrated Database (LIDB), which is intended to eventually replace and/or integrate many of its existing logistics systems. Army logistics officials have commented that the efforts taken to comply with the reporting requirements for national defense assets have been very beneficial to the Army because the process has resulted in more accurate property records which are used for procurement and deployment decisions.

The Air Force acknowledged that it was not able to identify all of its national defense assets for fiscal year 1999, but it is working to improve several of its logistics systems. It has reported that it is developing interfaces for all of its munitions systems so that manual procedures will not be necessary in the future to develop accurate missile data. It also expects to have complete, reliable information on all of its electronics systems pods in one logistics system by the end of this fiscal year.

Each of the services also made some progress toward improving information on additions and deletions activity during the year. For example, according to Air Force auditors, the Air Force now has accurate additions and deletions for its aircraft engines. The Army has considered a number of different options for tracking additions and deletions to its equipment, and while it does not yet have a solution in place, Army officials expect to have a plan to incorporate this information into their new Logistics Integrated Database by June 30, 2000. The Navy has developed new forms to better document additions and deletions for its boats and new procedures for documenting the transfer or disposal of aircraft engines.

In addition to the services' individual efforts, DOD is continuing to undertake initiatives to improve departmentwide asset visibility and tracking. The department's Global Combat Support System (GCSS) strategy—its approach to providing the technological base needed to rapidly deploy support to the warfighter—incorporates a number of such initiatives. For example, its Total Asset Visibility (TAV) initiative is intended to provide department-level access to timely and accurate information on the status, location, and movement of all assets, including national defense assets.

Because of the recognized problems with national defense asset information, and the lack of an audit requirement for these assets, the audit community in the past year focused on supporting and reviewing improvement efforts, rather than conducting any significant tests of data and systems. Under the National Defense Authorization Act for Fiscal Year 2000, the DOD Inspector General is required to review national defense asset data submitted to the Congress for fiscal year 1999. Such a review should help determine the success of DOD's improvement efforts so far, as well as identify those areas requiring further improvement.

Improvements in Environmental/ Disposal Liability Reporting But Additional Issues Need to Be Addressed

DOD has taken important steps to implement the federal accounting standards[31] requiring recognition and reporting of liabilities associated with environmental cleanup and disposal. The department issued accounting policy[32] consistent with these standards and has begun implementing those policies for nuclear weapons systems and training ranges, in addition to efforts already taken to address environmental restoration and chemical weapons disposal. In addition, working groups comprised of officials from the responsible DOD functional areas (such as Comptroller, Environmental Security, and Acquisition, Technology, and Logistics) and the audit community have been established.

DOD still faces significant challenges in this area. Specifically, (1) all potential liabilities were not considered, (2) estimates need to be refined to ensure that assumptions and methodologies are consistently applied, and (3) support for the basis of reported estimates continues to be inadequate. To ensure that the reported amounts of environmental and disposal liabilities are complete and reliable, adequately reflecting DOD's obligation to clean up and dispose of hazardous and other wastes, DOD will need to address these issues. While DOD has made great progress toward developing more complete estimates of these costs, until these efforts are complete, the Congress will not know the full extent of future resource requirements necessary to fund cleanup and disposal efforts based on current laws and policies.

DOD reported approximately $80 billion in estimated liabilities in its fiscal year 1999 financial statements, including for the first time approximately $34 billion for training range cleanup and nearly $11 billion for disposal of nuclear-powered aircraft carriers and submarines. For fiscal year 1998, only $34 billion was reported for estimated environmental liabilities. The time frame in which the fiscal year 1999 estimates were developed did not permit the audit community to perform adequate audit procedures to determine their reasonableness. DOD's failure to report these costs in prior years was among the most significant deficiencies that we previously reported to this Subcommittee.

[31] Statements of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government* and No. 6, *Accounting for Property, Plant, and Equipment.*

[32] DOD Financial Management Regulation, volume 4, chapter 13, *Accrued Environmental and Nonenvironmental Disposal Cost Liabilities* and chapter 14, *Accrued Environmental Restoration (Cleanup) Liabilities.*

Potential Liabilities Not Considered in Current Year Estimate

To date, DOD has focused on those liabilities expected to involve the largest amounts (nuclear weapons systems and training ranges). Going forward, DOD will need to address estimates for other weapons systems and conventional munitions. DOD needs to analyze the potential liability for disposing of these types of items and determine whether these estimates would be significant and thus need to be reported. If so, it will need to develop methodologies to support such estimates. Further, DOD has just begun to consider the significance of costs associated with the ultimate disposition of ongoing operations.

The Congress has also recognized the potential for significant costs associated with disposal. The National Defense Authorization Act for Fiscal Year 1995[33] required that the Secretary of Defense analyze the environmental costs of major defense acquisitions as part of the life-cycle costs of the programs. However, recent IG audits of several major weapons systems programs, including the Black Hawk helicopter and F-15 aircraft, have found that life-cycle cost estimates did not include costs for demilitarization, disposal, and associated cleanup.[34] These disposal cost estimates are important to consider before proceeding with a major acquisition because this information can contribute to the ongoing dialogue on funding comparable weapons systems. Compliance with the Fiscal Year 1995 Defense Authorization Act would also provide data critical to ensuring more complete and reliable financial statement reporting. In addition, the Senate Committee on Appropriations has required that DOD develop disposal cost estimates for munitions.[35]

DOD must also ensure consistent application of methods and assumptions regarding aircraft disposal cost estimates. The Navy's financial statements included an initial estimate of $331 million in fiscal year 1999 for disposal of fixed-wing and rotary-wing aircraft. However, although it reported twice as many aircraft as the Navy, the Air Force has not yet reported environmental and disposal liabilities for these weapons systems.

We are working with the department to identify other weapons systems that might have significant cleanup and disposal liabilities and approaches for estimating those liabilities. For example, the department's costs to

[33]Public Law 103-337, Oct. 5, 1994.

[34]*Hazardous Material Management for the Black Hawk Helicopter Program* (DOD IG Report No. 99-242, Aug. 23, 1999) and *Hazardous Material Management for the F-15 Aircraft Program* (DOD IG Report No. 00-012, Oct. 15, 1999).

[35]*Report on the Fiscal Year 1995 Defense Appropriations Bill* (Senate Committee on Appropriations, Senate Report 103-321, July 29, 1994).

dispose of conventionally powered ships would be at least $2.4 billion, based on applying the Navy's estimated average cost of $500 per ton of displacement used to estimate disposal costs for its inactive fleet. In addition, we previously estimated that the conventional munitions disposal liability for Army alone could exceed $1 billion.[36]

With regard to ongoing operations, costs of cleaning up and disposing of assets used in these operations may be significant. Significant environmental and disposal costs are to be recognized over the life of the related assets to capture the full cost of operations. We are working with DOD to assess whether operations, such as landfills and utilities (including wastewater treatment and power generation facilities), will ultimately have significant environmental costs associated with closure. For example, Edwards Air Force Base officials provided us with a landfill closure cost estimate of approximately $8 million. In addition, post-closure maintenance costs, such as monitoring in excess of $200,000 annually for 30 years, are not included in this estimate. To provide some perspective on the potential scope of these operations, the Army alone reported 65 landfills that, based on the Air Force estimated cost data, could cost nearly $1 billion to close and monitor.

Further, environmental and disposal costs must also be considered in the department's plans to analyze its more than 2,000 utility systems for privatization. If these costs prove significant to DOD, they should be considered in any cost-benefit analyses developed by the department in deciding to retain or privatize these functions.

Cleanup and Disposal Cost Estimates Need to Be Refined

Information on the estimated training range cleanup costs was not available in sufficient time prior to the statutory release date of the financial statements to enable the audit community to perform adequate work to determine the reasonableness of reported estimates. However, we were able to perform a limited analysis of DOD's first-time effort to develop complete cleanup cost estimates for training ranges. We previously testified on the significance of the department's unreported liability for training range cleanup, including removal and/or containment of unexploded ordnance and remediation of chemical contamination. DOD took initial steps to address this deficiency in fiscal year 1999 by reporting approximately $34 billion for cleanup of training ranges, accounting for

[36] *Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated* (GAO/AIMD-98-32, Dec. 19, 1997).

over 40 percent of its total reported environmental/disposal liabilities, which we view as an important step forward.

The training range cleanup liability is comprised primarily of cost estimates for active, inactive, and closed Navy/Marine Corps ranges of approximately $31 billion. The Navy reported this to be a minimum estimate based on assumptions of "low" contamination and cleanup/remediation to "limited public access" levels, for uses such as livestock grazing or wildlife preservation but not for human habitation. Based on these assumptions, the Navy used a cost factor of $10,000 per acre. Although the Army also has significant exposure for training range cleanup liabilities, it reported only $2.4 billion for ranges on formerly used defense sites and closed ranges on active installations. The Army assumed one closed training range per base for the active installations. However, because the Army has not developed a complete range inventory nor recorded any liability for active or inactive ranges, this approach may have significantly understated its liability. To illustrate the potential magnitude of Army training range cleanup, applying the cost factor used by the Navy to estimated range acreage of the Army's National Training Center at Ft. Irwin, California, would result in a cleanup cost estimate of approximately $4 billion for that installation alone.

DOD has cited the lack of guidance on the scope of range cleanup requirements as an impediment to reporting the cost of cleaning up the ranges. In this regard, DOD has been working with the Environmental Protection Agency (EPA) for several years to finalize the Range Rule that will provide a framework for developing an inventory of ranges and assessing the level of cleanup required.[37] After finalizing this rule, DOD will need to develop specific implementation guidance to ensure consistent application across the military services. This guidance will need to address the assumptions to be applied in estimating cleanup costs, including those related to risk levels and cleanup thresholds.

Cost estimates should also be refined for changes in cleanup/disposal schedules. For example, DOD reported a liability of approximately $8.9 billion in its fiscal year 1999 financial statements for chemical weapons disposal. Initial estimates to comply with the United Nations-sponsored Chemical Weapons Convention were based on a 2007

[37] On March 7, 2000, DOD and the Environmental Protection Agency issued Interim Final Management Principles to address ongoing range response actions until the final version of the Range Rule is promulgated.

completion date. However, we recently reported[38] that while 90 percent of the stockpile could be destroyed by the 2007 deadline, schedule slippages associated with the remaining 10 percent are likely to occur because of additional time required to validate, certify, and obtain approval of technologies to dispose of the remaining stockpile of chemical weapons. These schedule slippages will likely result in additional program costs. Historically, schedule delays have been found to increase direct costs such as labor, emergency preparedness, and program management.

Support for the Basis of Estimates Remains Inadequate

Last year the DOD IG reported[39] that the basis of estimates for significant recorded liabilities—primarily those related to restoration (cleanup) of sites contaminated from prior operations—was not adequately supported, and those problems persist. Service auditors continue to find that significant portions of the reported restoration liabilities lack adequate support for the basis of cost estimates. To address this deficiency, the Deputy Under Secretary of Defense (Environmental Security) issued a policy requiring that the basis of cost estimates be properly documented.[40] While this step is critical to resolving this issue, implementation issues remain, such as ensuring that the appropriate personnel receive the guidance and are properly trained on its implementation. For example, the Army Audit Agency found that the guidance was not properly disseminated to project managers and others preparing project cost estimates.[41]

Progress in Estimating Military Post-Retirement Health Care Liability

DOD provides health care benefits to military retirees and their families through its own military treatment facilities (MTF) and by using civilian providers. Each year, the DOD Office of Actuary and its contractors develop an estimate of DOD's future liability for providing these benefits. At September 30, 1999, the expected cost for future retiree health care benefits was estimated at $196 billion.

[38] *Chemical Weapons Disposal: Improvements Needed in Program Accountability and Financial Management* (GAO/NSIAD-00-80, May 8, 2000).

[39] *Data Supporting the DOD Environmental Line Item Liability on the FY 1998 Financial Statements* (DOD IG Report No. 99-209, July 9, 1999).

[40] *Supplemental Management Guidance for the Defense Environmental Restoration Program* (DOD Deputy Under Secretary of Defense (Environmental Security) Aug. 1999).

[41] *Army's General Fund Principal Financial Statements for Fiscal Year 1999: Financial Reporting of Liabilities* (Army Audit Agency Report No. AA 00-220, Apr. 21, 2000).

In last year's testimony, we reported that DOD's estimated retiree health benefits liability was unreliable because DOD did not have accurate and complete cost data on which to base its calculation, used old and incomplete historical claims data, and relied on unsupported clinic workload data related to outpatient visits. Although these problems still exist, the Office of Actuary and Office of Health Affairs have made meaningful progress in improving the processes and underlying data on which the liability estimate is based. For example, the liability reported in fiscal year 1998 was based on 1994 claims data—a 4-year lag—while the 1999 liability was based on 1997 data—a 2-year lag. Moreover, the 1998 liability used outpatient claims data from only 15 of 121 MTFs while the 1999 liability had outpatient information for all MTFs. Better and more complete data resulted in a $37.5 billion decrease, nearly 17 percent, in DOD's estimated liability for retiree health benefits. These kinds of improvements in claims and workload data will also benefit DOD's ability to manage its health care programs, make health care-related decisions, such as whether to outsource certain medical treatments or provide them in MTFs, and evaluate legislative options regarding benefit changes.[42]

To help focus improvement efforts, the Office of Actuary recently conducted a thorough analysis of the various factors that affect the magnitude and reliability of its actuarial estimate. The analysis identified assumptions regarding future interest rates and medical trends, program withdrawal and death rates, and measures of current cost and services provided as the key drivers of the future cost of health care benefits. This type of analysis is important because it shows that, for example, if current MTF costs change by only 1 percent, DOD's future liability will change by more than a billion dollars.

Despite the sensitivity of the liability to current costs, DOD has had to use obligations in its calculation and for making many program decisions because it does not have actual cost information for its MTFs. However, budget obligations do not reflect the full cost of providing health care because they do not include, among other things, civilian employee retirement benefits that are paid directly out of the Civil Service Retirement and Disability Fund rather than by DOD or depreciation costs for medical facilities and equipment. In addition, health program budget obligations attributable to wartime readiness are not distinguishable from

[42]In recent testimony before the House Subcommittee on Military Personnel, we discussed several legislative proposals that have been introduced to expand and enhance military health benefits for older retirees. See *Defense Health Care: Observations on Proposed Benefit Expansion and Overcoming TRICARE Obstacles* (GAO/T-HEHS/NSIAD-00-129, Mar. 15, 2000).

those associated with peacetime care.[43] Consistent with our prior advice, DOD now agrees that full cost should be used to estimate the retirement health benefits liability and plans to do so for fiscal year 2000. To this end, representatives from Health Affairs, the Comptroller's Office, Office of Actuary, DOD Inspector General and GAO have established a Full Cost Working Group, which has begun addressing the completeness and accuracy of recorded costs as well as determining the portion of health care costs associated with retirees. In addition to improving the liability estimate, DOD needs reliable cost data to properly allocate health care resources, decide whether to outsource certain services, set third party billing and interagency cost rates, and benchmark its health care delivery system with those of other providers.

The proper allocation and growth rate of pharmacy costs are other factors that could have a significant impact on future retiree health care costs. For purposes of calculating the liability, DOD has been making the assumption that its patient population uses pharmacy resources equally; however, preliminary evidence suggests that retirees use more outpatient pharmacy resources than nonretirees. Furthermore, pharmacy costs are increasing at a faster rate than other medical costs, yet DOD has been applying the same medical trend rate to all outpatient costs. We estimated that DOD pharmacy costs increased 13 percent from 1995 through 1997, while its overall health care costs increased 2 percent for that period.[44] DOD is currently analyzing the effect of separately estimating the pharmaceutical component of the health benefits liability. This analysis will be even more important if legislation currently being proposed, which includes increased pharmacy benefits for retirees eligible for Medicare, is enacted.[45]

DOD and its auditors have identified other needed improvements in patient care and demographic data. DOD has been using examples of blatant data errors, such as negative costs for some surgery clinics and obstetrics services provided to male patients, to stress to its own staff and to health care contractors the importance of its improvement efforts.

[43]Wartime readiness refers to maintaining the health of service members and treating wartime casualties, whereas peacetime care refers to providing for the health care needs of the families of active-duty members, retirees, and their families and survivors.

[44]*Defense Health Care: Fully Integrated Pharmacy System Would Improve Service and Cost-Effectiveness* (GAO/HEHS-98-176. June 12 , 1998).

[45]Proposed legislation to expand Medicare-eligible uniformed services retirees' eligibility for certain Defense pharmacy programs was introduced in the Senate on January 27, 2000, as S.2013, the "Honoring Health Care Commitments to Servicemembers Past and Present Act of 2000."

Similarly, the DOD IG[46] has reported that workload data are problematic—medical services cannot be validated either because medical records are not readily available or outpatient visits are not adequately documented. The DOD IG also reported that MTF outpatient visits are often double counted and that many telephone consultations have been incorrectly counted as visits, perhaps due to the lack of standardized appointment types. An accurate count of patient visits by clinic and type is necessary for DOD to make the proper allocations of medical personnel, supplies, and funding.

To address access and workload shortcomings, DOD recently issued a letter directing MTFs to ensure that medical records are readily available and has begun moving toward standardized appointment types and to electronic patient records that would be accessible by all MTFs. DOD also established a Data Quality Integrated Program Team, which is currently considering other data quality improvements. In addition, DOD has developed procedures for reconciling financial, workload, and labor hours to the data sources. When fully and effectively implemented, these procedures should improve the reliability of underlying data used in managing DOD's health care programs.

DOD Net Cost Information Is Unreliable

Our audit of the U.S. government's consolidated financial statements for fiscal year 1999 found that the government was unable to support significant portions of the $1.8 trillion reported as the total net cost of government operations. Federal accounting standards require federal agencies to accumulate and report on the full costs of their activities.[47] DOD, which represents $378 billion of the $1.8 trillion, was not able to support its reported net costs. Although we have seen some improvements in DOD's ability to produce reliable financial information, as noted throughout this testimony, capturing and accurately reporting the full cost of its programs remains one of the most significant challenges DOD faces.

DOD needs reliable systems and processes to appropriately capture the required cost information from the hundreds of millions of transactions it processes each year. To do so, DOD must perform the basic accounting

[46] *Data Supporting the FY 1998 DOD Military Retirement Health Benefits Liability Estimate* (DOD IG Report No. 99-127, Apr. 7, 1999).

[47] Statement of Federal Financial Accounting Standards No. 4 , *Managerial Cost Accounting Standards*, requires accumulating the full cost associated with an entity's output through appropriate costing methodologies or cost-finding techniques.

activities of entering these transactions into systems that conform to established systems requirements, properly classifying transactions, analyzing data processed in its systems, and reporting in accordance with requirements. As discussed later, this will require properly trained personnel, simplified processes, systems supporting operational and accounting needs, and a disciplined approach for accomplishing these steps.

Because it does not have the systems and processes in place to reliably accumulate costs, DOD is unable to account for several significant costs of its operations, as discussed in this testimony. Specifically, the accuracy of the department's reported operating costs was affected by DOD's inability to

- properly value and capitalize its facilities and equipment,
- properly account for and value its inventory,
- identify the full extent of its environmental and disposal liability,
- determine its liability associated with post-retirement health care for military personnel, and
- complete the reconciliation of its records with those of the Department of the Treasury.

In addition, DOD did not have adequate managerial cost accounting systems in place to collect, process, and report its $378 billion in total reported fiscal year 1999 net operating costs by program area consistent with federal accounting standards.[48] Instead it used budget classifications such as military construction, procurement, and research and development to present its cost data. In general, the data DOD reported in its financial statements represented disbursement data for those budgetary accounts, adjusted for estimated asset purchases and accruals. For financial reports other than the financial statements, DOD typically uses obligation data as a substitute for cost. As discussed later in this testimony, DOD budget data are also unreliable.

[48]Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Standards* (July 31, 1995) and *Internal Controls and Compliance With Laws and Regulations for the DOD Agency-Wide Financial Statements for FY 1999* (DOD IG Report No. D-2000-091, Feb. 25, 2000).

To manage DOD's programs effectively and efficiently, its managers need reliable cost information. This information is necessary to (1) evaluate programs, such as by measuring actual results of management's actions against expected savings or determining the effect of long-term liabilities created by current programs, (2) make economic choices, such as whether to outsource specific activities and how to improve efficiency through technology choices, (3) control costs for its weapons systems and business activities funded through the working capital funds, and (4) measure performance.

The lack of reliable, cost-based information hampers DOD in each of these areas as illustrated by the following examples.

- DOD is unable to provide actual data to fully account for the costs associated with functions studied for potential outsourcing under OMB Circular A-76. We recently reported on a long-standing concern over how accurately DOD's in-house cost estimates used in A-76 competitions reflect actual costs.[49]
- DOD has acknowledged that its Defense Reform Initiative efforts have been hampered by limited visibility into true ownership costs of its weapons systems. Specifically, the department cited inconsistent methods used by the military services to capture support cost data and failure to include certain costs as limiting the utility of existing weapons system cost data. DOD has also acknowledged that the lack of a cost accounting system is the single largest impediment to controlling and managing weapon systems costs, including costs of acquiring, managing, and disposing of weapon systems.
- DOD has long-standing problems accumulating and reporting the full costs associated with its working capital fund operations, which provide goods and services in support of the military services. Cost is a key performance indicator to assess the efficiency of working capital fund operations. For example, we recently reported[50] that the Air Force's Air Mobility Command—which operated using a working capital fund—lacked accurate cost information needed to set rates to charge its customers and assess the economy and efficiency of its operations. We separately reported that Air Force depot maintenance officials acknowledged that

[49] *DOD Competitive Sourcing: Lessons Learned System Could Enhance A-76 Study Process* (GAO/NSIAD-99-152, July 21, 1999).

[50] *Defense Transportation: More Reliable Information Key to Managing Airlift Services More Efficiently* (GAO/NSIAD-00-6, Mar. 6, 2000).

they lack all the data needed to effectively manage their material costs.[51] As a result, DOD is unable to reliably assess the economy and efficiency of its business-like activities financed with working capital funds.

Reliability of Budget Data Impaired

In its financial statements, DOD is required to report the activity in and status of its budget accounts. The Statement of Budgetary Resources, one of the basic financial statements, presents information, such as outlays and obligated and unobligated balances, at the end of the year. This statement also should reconcile to Fund Balance with Treasury accounts, which represent DOD's balances available for disbursement. In addition, DOD's outlays should agree with the activity in these Treasury accounts for the year.

DOD auditors were unable to complete their audits of the Statements of Budgetary Resources because they found that obligated balances were not correct, disbursements were not properly recorded, and Fund Balances with Treasury remained unreliable. In addition to the specific improvement initiatives referred to in this section, the ultimate resolution of DOD's long-standing problems in maintaining reliable budgetary data will depend on the process improvements, enhanced training, and systems efforts discussed later in this testimony.

Obligated Balances Were Incorrect and Unsupported

In their testing of obligated balances, auditors found evidence of unsupported obligations and poor internal controls over obligations, as illustrated by the following examples.

- The Army Audit Agency found[52] that internal controls over the recording of obligations were not adequate to ensure that amounts reported in the Army's General Fund Statement of Budgetary Resources for fiscal year 1999 were accurate. In a sample of 60 transactions, the auditors found that 21 could not be supported.
- For fiscal year 1999, audit results[53] show that the Air Force Working Capital Fund had $211 million of obligations out of approximately

[51] *Air Force Depot Maintenance: Analysis of Its Financial Operations* (GAO/AIMD/NSIAD-00-38, Dec. 10, 1999).

[52] *Army's General Fund Principal Financial Statements for Fiscal Year 1999, Financial Reporting of Budgetary Resources* (U.S. Army Audit Agency Report No. AA 00-223, Apr. 28, 2000).

[53] *Opinion on Fiscal Year 1999 Air Force Working Capital Fund Financial Statements* (Air Force Audit Agency Report No. 99068011, Feb. 9, 2000).

$1 billion tested, that is 700 out of 2,526 transactions that were incorrect, inadequately supported, or not supported. In addition, Air Force's general fund audit continued to identify inaccurate or unsupported obligated balances as of September 30, 1999. Specifically, Air Force auditors identified an estimated $1.3 billion in inaccurate or unsupported obligated balances. However, this represents a significant improvement over the prior year when an estimated $4 billion in obligated balances were inaccurate or unsupported.

- In addition to auditors' reports, the Department of the Navy identified its unliquidated and invalid obligations as a material management control weakness in its fiscal year 1999 annual assurance statement issued pursuant to the Federal Managers' Financial Integrity Act.[54] For example, the Navy reported that within the Operation and Maintenance-Navy appropriation, some activities were not verifying that only valid obligations were entered into the accounting system. As a result, funding may have been available but not used. In addition, the Navy had more than $1 billion in expired budget authority that was allowed to cancel at the end of fiscal year 1999, including more than $750 million that had been obligated but not disbursed. According to Treasury data, at the end of fiscal year 1999, the department had $3.8 billion in expired budget authority that canceled.

  Further, major Navy commands were deobligating funds from subordinate commands without the subordinate's knowledge and approval. As a result, valid obligations could have been deobligated. These procedures demonstrate a lack of adequate internal controls over the obligation process, which is intended to ensure that liabilities are recognized against available funding and that overspending does not occur.

Disbursements Not Properly Recorded

Problem disbursements—disbursements that are not properly matched to specific obligations recorded in the department's records—continue to impede the department's efforts to improve its budgetary data. This situation can misstate DOD's reported obligated balances, undermining this important budgetary control. For example, when disbursements are not matched to specific obligations, an understatement of obligations and an overdisbursement of an account can occur. This situation occurs if the disbursement is for an item for which an obligation has not been recorded

[54] The Federal Managers' Financial Integrity Act of 1982 requires federal agencies to annually assess controls and report on internal control and accounting system deficiencies, along with the status of related corrective actions.

or if the amount of the recorded obligation is less than the recorded disbursement. Obligations are also understated in the case of in-transits, in which a disbursement has been made but documentation is insufficient to determine how the transaction should be recorded in the accounting records.

The DOD Comptroller's Office stated in the fiscal year 1999 financial statements that the elimination of problem disbursements is one of the department's highest financial management priorities. DOD has reported progress in resolving problem disbursements. As of September 30, 1999, DOD reported[55] $10.5 billion in problem disbursements, including in-transits, as compared with about $17.3 billion in problem disbursements reported at the end of fiscal year 1998.

Of the $10.5 billion, DOD reported that about $1.5 billion were problem unmatched disbursements and negative unliquidated obligations (NULOs)[56] over 180 days old. DOD's problem disbursement policy requires that obligations be recorded for amounts paid that are unmatched to a recorded obligation or exceed recorded obligated balances after 180 days. However, the policy makes an exception if sufficient funds are not available for obligation. In that case, DOD's policy permits the department to delay recording an obligation or adjustment until the funds cancel—up to 5 years after expiration of the account. DOD believes that by delaying the recording of the obligation, funds will become available—for example, through de-obligation–thus permitting the obligation to be recorded without incurring a potential Antideficiency Act violation[57] and ensuing investigation. If DOD had recorded this $1.5 billion after the transactions remained unmatched for 180 days, the related account balances would have reflected potential Antideficiency Act violations and required an investigation and report to the Congress.

An agency may not avoid the requirements of the Antideficiency Act, including its reporting requirements, by failing to record obligations or to investigate potential violations. To ensure sound funds control and

[55]Defense Finance and Accounting Service reports to the DOD Comptroller on problem disbursements and in-transits as of September 30, 1999.

[56]Negative unliquidated obligations (NULOs) are disbursements that have been received and posted to specific obligations by the accounting station, but the recorded disbursements exceed the recorded obligations.

[57]The Antideficiency Act provides that an officer or employee of the United States Government may not "make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund" or enter into a contract or other obligation for payment of money "before an appropriation is made." (31 U.S.C. 1341 (a)).

compliance with the Antideficiency Act, an agency's fund control system must record transactions as they occur. We and the DOD IG have previously reported[58] on this issue and recommended that DOD revise its problem disbursement policies and procedures to ensure that accurate and reliable balances are maintained.

Finally, due to improper and unsupported DOD payments, such as the problem disbursement issues previously discussed, the true magnitude of DOD's payment problems is unknown. For example, our work continues to identify problems with overpayments and erroneous payments to contractors. For fiscal years 1994 through 1999, defense contractors returned over $5.3 billion to the DFAS Columbus Center, including $675 million during fiscal year 1999, due to contract administration actions and payment processing errors.

Frequent Adjustments Affect Reliability

DOD frequently adjusts recorded payments to record the payment to another appropriation account, including to canceled appropriations. These adjustments raise questions about the reliability of amounts reported as obligated and available for disbursement. In March 2000, we reported[59] that about one of every two dollars in fiscal year 1997 contract payment transactions processed was for adjustments to previously recorded disbursement transactions. Although DOD reported that the number of adjustments has declined, it remains significant. During fiscal year 1999, DFAS data showed that almost one of every three dollars in contract payment transactions was for adjustments to previously recorded payments—$51 billion in adjustments out of $157 billion in transactions. These adjustments were often made to original entries that were recorded years earlier. Many of the adjustments selected during our review were made to canceled accounts.

In the National Defense Authorization Act for Fiscal Year 1991, the Congress changed the government's account closing procedures. The intent of the changes was to impose the discipline of the Antideficiency Act and the bona fide needs rule[60] to expired appropriations and to ensure

[58] *Financial Management: Problems in Accounting for Navy Transactions Impair Funds Control and Financial Reporting* (GAO/AIMD-99-19, Jan. 19, 1999) and *Recording Obligations in Official Accounting Records* (DOD IG Report No. D-2000-030, Nov. 4, 1999).

[59] *Financial Management: Differences in Army and Air Force Disbursing and Accounting Records* (GAO/AIMD-00-20, Mar. 7, 2000).

[60] The bona fide needs rule, based on 31 U.S.C. 1502(a), requires that agencies use appropriations available for obligation for a limited period of time to meet the legitimate needs of the agency arising during that period of time.

that expired appropriations do not remain open on the government's books indefinitely. Under the account closing law, 31 U.S.C. 1551-1558, agencies must continue to account for the obligated and unobligated balances of their appropriations for 5 years after the expiration of their period of availability. At the end of 5 years, appropriation balances, both obligated and unobligated, are canceled. After that time, they are no longer available for obligation, obligation adjustment, or expenditure for any purposes.[61] Because these accounts are no longer available for disbursement, they are not reported as part of DOD's Fund Balance with Treasury or in the department's Status of Funds reports to OMB or the Congress.

Subsequent to the amendment of the account closing law, DOD requested that Treasury reopen hundreds of closed accounts to permit the posting of adjustments. Treasury asked us whether it had authority to correct reporting or accounting errors in closed accounts. In 1993, we determined that Treasury had authority to correct these errors.[62] However, our decision emphasized that "Treasury's authority to correct the accounts relates only to obvious clerical errors such as misplaced decimals, transposed digits, or transcribing errors that result in inadvertent cancellations of budget authority, and is not meant to serve as a palliative for deficiencies in DOD's accounting systems."[63] The decision also concluded that Treasury may adjust canceled appropriations to record disbursements that were in fact made before the cancellation. However, Treasury can make these adjustments only if DOD can establish that a disbursement was a liquidation of a valid obligation, recorded or unrecorded, that was properly chargeable against a closed account.[64]

Adjusting disbursements previously recorded to current or expired accounts by moving those transactions to canceled accounts can change balances available for obligation in the current accounts or obligated balances in expired accounts. Since the 1991 account closing law was enacted, DOD has requested that Treasury reopen 333 closed accounts, restoring a total of $26 billion. These accounts remained open as of

[61] Obligation adjustments and liquidations (expenditures) that an agency would otherwise have charged against the expired appropriation are, at this point in time, chargeable against a current appropriation for the same purpose, but only to the extent of the lesser of 1 percent of the current appropriation or unexpended balance of the closed account (31 U.S.C. 1553(b)).

[62] 72 Comp. Gen. 343 (1993).

[63] 72 Comp. Gen. at 346 (1993).

[64] 72 Comp. Gen. at 347 (1993).

September 30, 1999. By comparison, all other federal agencies combined have requested that Treasury reopen 21 closed accounts, restoring a total of $5 million. According to Treasury's records, DOD made $576 million in net adjustments to canceled accounts in fiscal year 1999. DOD has indicated that it has controls in place to ensure that adjustments to canceled accounts are proper. We expect to begin a review in this area to ensure that DOD's adjustments to closed accounts comply with the account closing law and the 1993 Comptroller General decision.

Fund Balance With Treasury Remains Unreliable

Although an agency is responsible for determining and maintaining its available fund balance, Treasury also has information about activity in the agency's account, and Treasury's and the agency's records must be periodically reconciled to determine the actual amount of funds available. Although DOD has made some improvements in its accountability over these funds, the amount of funds available at DOD remains questionable because significant differences between DOD and Treasury's records remain and items in suspense accounts may or may not reflect DOD activity.

DOD made the reduction of differences a high priority in its short-term improvement plans last year. DFAS began standardizing the reconciliation procedures and adjusting the differences. This effort resulted in a drop in the absolute value of unresolved differences from $9.6 billion at September 30, 1998, to $7.3 billion at September 30, 1999. In addition, some DOD components have significantly improved the process and reduced the amount of unreconciled differences. The Army's Corps of Engineers, Civil Works, formed special teams to research and resolve differences identified by Treasury on a monthly basis. The efforts of these special teams resulted in a substantial reduction in unreconciled differences. For example, the absolute value of unreconciled differences for the Corps of Engineers at September 30, 1999, was $64 million—down from $423 million on September 30, 1998.

Although some of these unreconciled differences may be due to the timing of transaction processing at Treasury versus DOD, an aging of the difference demonstrates that reconciliation issues remain. For example, although $4.8 billion of the absolute difference is less than 60 days old, $1.2 billion is 60 days to 1 year old, and $1.3 billion is over 1 year old. Differences over 60 days old are generally not expected to be attributable to timing.

At least some of the decrease in the total differences can be attributed to the practice of some DFAS center staff to routinely adjust their records each month to match those at Treasury without first identifying whether the adjustment is proper. This practice results in fewer differences on the reports but does not necessarily mean that the reconciliation process has actually improved or that the causes of the differences have been addressed and resolved. For example, one Army disbursing station recorded $608 million in differences to a suspense account.[65] These differences were ultimately charged to Operations and Maintenance at year-end to avoid showing this amount on the Statement of Differences.

Finally, DOD records show that an estimated $1.6 billion of transactions held in suspense accounts at the end of fiscal year 1999 have not been properly reported to Treasury and may also affect the fund balance with Treasury amount. DOD reported $823 million in suspense accounts at the end of fiscal year 1998. Until suspense account transactions are posted to the proper appropriation account, the department will have little assurance that it has a right to the collections, that adjustments are valid, and that the disbursements do not exceed appropriated amounts. Moreover, the reported amounts in suspense accounts represent the offsetting (netting) of collections and adjustments against disbursements, thus understating the magnitude of the unrecorded amounts in suspense accounts.

Computer Security Weaknesses Continue to Undermine Financial Management and Other Operations

DOD relies on a vast and complex computerized information infrastructure to support virtually all aspects of its operations, including strategic and tactical operations, weaponry, intelligence, and security. This reliance extends to its business operations that support the department, including financial management. In recent years, internal and external evaluations have identified weaknesses in information security that could seriously jeopardize DOD's operations and compromise the confidentiality, integrity, or availability of sensitive information, including data that are recorded in or transmitted by the department's financial management systems. In September 1996, we issued a report with limited distribution that identified pervasive information security weaknesses in DOD. We reported that DOD lacked a departmentwide information security program to comprehensively address the general control weaknesses we had identified.

While not unmindful of the computer security weaknesses of its financial management and other critical computer system operations, until recently,

[65] A suspense account is a temporary holding account for problem transactions—for example, those rejected because of system edit controls.

the department has necessarily focused its efforts on preparing its computer infrastructure for the Year 2000. However, with that challenge successfully addressed, DOD can now turn even greater attention to countering cyber threats and protecting its information systems in support of both warfighting and its financial management and other business missions.

In some areas, the Year 2000 effort has laid a foundation for long-term improvement in the way federal agencies view, manage, and protect computer systems supporting critical missions. Among the lessons learned were the importance of understanding the significance of computer-supported operations and the extensive dependence agencies have on computers. This dependence has heightened DOD's exposure and vulnerability to a rapidly growing number of sophisticated internal and external cyber threats. As such, DOD reports that it is firmly embarked on improving its overall information assurance posture. For example, we recently reported to the Special Committee on the Year 2000 Technology Problem[66] that DOD expects funding for computer-network defense to increase significantly for fiscal years 2001 through 2005. DOD reports that this funding is in support of its efforts to improve computer security capabilities and to manage and strengthen its information assurance posture.

As laid out in our 1998 Executive Guide[67] on information security management, establishing and effectively implementing a computer security program should establish a process and assign responsibilities for systematically (1) assessing risk, (2) developing and implementing effective security policies and controls, (3) promoting security awareness, (4) monitoring the appropriateness and effectiveness of these policies and related controls, and (5) providing feedback to managers who may then make needed adjustments. In February 1997, we included information security in our list of government program areas at high risk for waste, fraud, abuse, and mismanagement, a designation that continued in last year's update.[68]

[66] *Computer Security: Reported Appropriations and Obligations for Four Major Initiatives* (GAO/AIMD-00-92R, Feb. 28, 2000).

[67] *Executive Guide: Information Security Management—Learning From Leading Organizations* (GAO/AIMD-98-68, May 1, 1998).

[68] *High-Risk Series: Information Management and Technology* (GAO/HR-97-9, Feb. 1997); *High-Risk Series: An Update* (GAO/HR-99-1, Jan. 1999); and *Major Management Challenges and Program Risks: Department of Defense* (GAO/OCG-99-4, Jan. 1999).

Although many factors contribute to these weaknesses, audits by GAO and Inspectors General have found that an underlying cause of weak information security is poor management of security programs. In August 1999, we reported[69] that serious weaknesses in DOD's information security–at both the department and component levels–continued to provide hackers and hundreds of thousands of authorized users the opportunity to modify, steal, inappropriately disclose, and destroy sensitive data. Moreover, they endanger other important DOD-wide functions, such as weapons and supercomputer research, logistics, procurement, personnel management, and military health. In fact, attackers have stolen, modified, and destroyed both data and software at DOD. They have installed "back doors" that circumvented normal system protection and allowed attackers unauthorized future access. They have also shut down and crashed entire systems and networks.

In particular, we found that DOD lacked adequate (1) controls over access to sensitive systems and data, (2) controls over software development and changes, (3) segregation of duties, (4) system software controls, and (5) continuity of service plans. For example, we found that users were granted access to computer resources that exceeded what they required to carry out their job responsibilities, including sensitive system privileges for which they had no need. In addition, we found that personnel were still being assigned both systems programming and security administration duties. This dual assignment would enable users for example, to modify payroll records or shipping records to generate unauthorized payments or misdirect inventory shipments and to suppress the related system audit data to avoid detection.

At the time of our 1999 review, in response to our recommendations, DOD was developing but had not yet implemented a departmentwide security program—known as the Defense-wide Information Assurance Program (DIAP). DIAP planning documents, which incorporate at a high level most of the best practices associated with information security management, indicate that DOD recognizes and is attempting to establish the departmentwide structure needed to manage the complex information security risks associated with its heavy reliance on computer systems. Also, in December 1998, a newly created Joint Task Force for Computer Network Defense began coordinating and directing the defense of DOD computer systems and networks against strategic attack. Its functions include (1) situation monitoring and assessment, (2) directing DOD

[69] *DOD Information Security: Serious Weaknesses Continue to Place Defense Operations at Risk* (GAO/AIMD-99-107, Aug. 26, 1999).

actions to stop attacks, contain damage, restore functionality, and provide feedback to users, (3) coordinating DOD defensive actions with other government agencies and private organizations, as appropriate, (4) participating in joint training exercises, and (5) developing contingency plans and techniques. We currently have a review under way to determine how well these improvements are being implemented and whether they are being effectively coordinated.

We also made recommendations in our earlier reports aimed at ensuring that information security programs of the military departments and Defense agencies were consistent with the departmentwide security program. This recommendation came partly as a result of persistent general control weaknesses at many military installations, including unauthorized access to sensitive information and weak controls over key automated data processing operations used to support accounting and operational systems. Our recently completed general and application control review of one DOD component's key financial management system identified similar weaknesses.

Preliminary results of this review identified serious weaknesses in access controls and systems software. For example, we gained access to sensitive information through a file that was publicly available over the Internet. Without valid user authentication, we gained access to employees' social security numbers, addresses, and pay information, as well as budget, expenditure, and procurement information on projects. This component is taking corrective actions consistent with DOD's overall information assurance initiatives.

Integrated Financial Management System Using Year 2000 Approach

Establishing an integrated financial management system—including both automated and manual processes—will be key to reforming DOD's financial management operations. DOD has acknowledged that its present system has long-standing inadequacies and does not, for the most part, comply with federal system standards. DOD has set out an integrated financial management system goal. Further, the department is now well-positioned to adapt the lessons learned from addressing the Year 2000 issue and our recently issued survey of the best practices of world-class financial management organizations[70] and to use the information technology investment criteria included in the Clinger-Cohen Act of 1996.

[70] *Executive Guide: Creating Value Through World-class Financial Management* (GAO/AIMD-00-134, Apr. 2000).

Integrated Financial Management System Needed

Establishing an integrated system is central to the framework for financial reforms set out by the Congress in the Chief Financial Officers (CFO) Act of 1990 and the Federal Financial Management Improvement Act (FFMIA) of 1996. Specifically, among the requirements of the CFO Act is that each agency CFO develop an integrated agency accounting and financial management system. Further, FFMIA provided a legislative mandate to implement and maintain financial management systems that substantially comply with federal financial management systems requirements, including the requirement that federal agencies establish and maintain a single, integrated financial management system.[71]

The department faces a significant challenge in integrating its financial management systems because of its size and complexity and the condition of its current financial management operations. DOD is not only responsible for an estimated $1 trillion in assets and liabilities, but also for providing financial management support to personnel on an estimated 500 bases in 137 countries and territories throughout the world. DOD has also estimated that it makes $24 billion in monthly disbursements, and that in any given fiscal year, the department may have as many as 500 or more active appropriations. Each service operates unique, nonstandard financial processes and systems. In describing the scope of its challenge in this area, DOD recognized that it will not be possible to reverse decades-old problems overnight.

DOD submitted its first *Financial Management Improvement Plan* to the Congress on October 26, 1998. We reported[72] that DOD's plan represented a great deal of effort and provided a first-ever vision of the department's future financial management environment. In developing this overall concept of its envisioned financial management environment, DOD took an important first step in improving its financial management operations. DOD's 1999 update to its *Financial Management Improvement Plan* set out an integrated financial management system as the long-term solution for establishing effective financial management. As part of its 1999 plan, DOD reported that it relies on an inventory of 168 systems to carry out its financial management responsibilities. This financial management systems inventory includes 98 finance and accounting systems and 70 critical

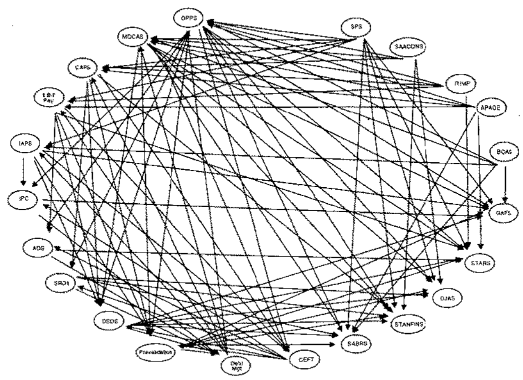
[71]Office of Management and Budget Circular A-127 defines an integrated financial management system as a unified set of financial systems and the financial portions of mixed systems encompassing the software, hardware, personnel, processes (manual and automated), procedures, controls, and data necessary to carry out financial management functions of an agency, manage financial operations of an agency, and report on an agency's financial status to central agencies, Congress, and the public.

[72]*Financial Management: Analysis of DOD's First Biennial Financial Management Improvement Plan* (GAO/AIMD-99-44, Jan. 29, 1999).

feeder systems—systems owned and operated by functional communities throughout DOD, such as personnel, acquisition, property management, and inventory management. The inclusion of feeder systems in the department's inventory of financial management systems is a significant landmark because of the importance of the programmatic functions to the department's ability to carry out not only its financial reporting but also its asset accountability responsibilities. The department has reported that an estimated 80 percent of the data needed for sound financial management comes from these feeder systems. However, DOD has also acknowledged that overall, its financial management systems do not comply with the FFMIA federal financial management systems requirements.

DOD presently lacks the integrated, transaction-driven, double entry accounting systems that are necessary to properly control assets and accumulate costs. As a result, millions of transactions must be keyed and rekeyed into the vast number of systems involved in a given business process. To illustrate the degree of difficulty that DOD faces in managing these complex systems, the following figure shows for one business area—contract and vendor payments—the number of systems involved and their relationship to one another.

Figure 1: DOD's Current Systems Environment for the Contract and Vendor Payment Process



Source: Department of Defense.

In addition to the 22 financial systems involved in the contract payment process that are shown in figure 1, DFAS has identified many other critical acquisition systems used in the contract payment process that are not shown on this diagram. To further complicate the processing of these transactions, each transaction must be recorded using a nonstandard, complex line of accounting that accumulates appropriation, budget, and management information for contract payments. Moreover, the line of accounting code structure differs by service and fund type. For example, the following line of accounting is used for the Army's Operations and Maintenance appropriation.

2162020573106325796.BD26FBQSUPCA200GRE12340109003AB22WORNAAS34030

Because DOD's payment and accounting processes are complex, and generally involve separate functions carried out by separate offices using different systems, the line of accounting must be manually entered multiple times, which compounds the likelihood of errors. An error in any one character in such a line of code can delay payment processing or affect the reliability of data used to support management and budget decisions. In either case, time-consuming research must then be conducted by DOD staff or by contractor personnel to identify and correct the error. Over a period of 3 years, one DOD payment center spent $28.6 million for a contractor to research such errors.

The combination of nonintegrated systems, extremely complex coding of transactions, and poor business processes have resulted in billions of dollars of adjustments to correct transactions processed for functions such as inventory and contract payments. As stated previously, during fiscal year 1999, almost one of every three dollars in contract payment transactions was made to adjust a previously recorded transaction. In addition, the DOD IG found that $7.6 trillion of adjustments to DOD's accounting transactions were required last year to prepare DOD's financial statements.

DOD Adopts Year 2000 Approach

As we testified last year, DOD has a unique opportunity to capitalize on the valuable lessons it has learned in addressing the Year 2000 issue and apply them to its efforts to reform financial management. The Year 2000 approach is based on managing projects as critical investments and uses a structured five-phase process, including awareness, assessment, renovation, validation, and implementation. Each phase represents a major program activity or segment that includes (1) specific milestones, (2) independent validation and verification of system compliance, and (3) periodic reporting on the status of technology projects. During the department's Year 2000 effort, DOD followed this structured approach and (1) established interim dates or milestones for each significant aspect of the project, (2) used auditors to provide independent verification and validation of systems compliance, and (3) periodically reported the status of its efforts to OMB, the Congress, and the audit community.

To successfully adapt this structured, disciplined process to DOD's current financial management improvement initiatives, DOD must ensure that the lessons learned in addressing the Year 2000 effort and from our financial management best practices survey are effectively applied. In this regard, two important lessons should be drawn from the Year 2000 experience—the importance of (1) focusing on process improvement instead of systems compliance and (2) strong leadership at the highest levels of the department to ensure the reform effort becomes an entitywide priority.

End-to-End Business Process Focus

Establishing the right goal is essential for success. Initially, DOD's Year 2000 focus was on information technology and systems compliance. This process was geared toward ensuring compliance system by system and did not appropriately consider the interrelationship of all systems within a given business process. However, DOD eventually shifted to a core mission and function approach and greatly reduced its Year 2000 risk through a series of risk mitigation measures including 123 major process end-to-end evaluations. Through the Year 2000 experience, DOD has learned that the goal of systems improvement initiatives should be improving end-to-end business processes, not systems compliance.

This concept is also consistent with provisions of the Clinger-Cohen Act of 1996 and related system and software engineering best practices, which provide federal agencies with a framework for effectively managing large, complex system modernization efforts. This framework is designed to help agencies establish the information technology management capability and controls necessary to effectively build modernized systems. For example, the act requires agency chief information officers to develop and maintain an integrated system architecture. Such an architecture can guide and constrain information system investments, providing a systematic means to preclude inconsistent system design and development decisions and the resulting suboptimal performance and added cost associated with incompatible systems. The act also requires agencies to establish effective information technology investment management processes whereby (1) alternative solutions are identified, (2) reliable estimates of project costs and benefits are developed, and (3) major projects are structured into a series of smaller increments to ensure that each constitutes a wise investment.

The financial management concept of operations included in DOD's *Financial Management Improvement Plan* should fit into the overall system architecture for the department developed under the provisions of the Clinger-Cohen Act. In addition, the goal of DOD's *Financial Management Improvement Plan* should be to improve DOD's business processes in order to provide better information to decisionmakers and ensure greater control and accountability over the department's assets. However, we reported last year,[73] the vision and goals the department established in its *Financial Management Improvement Plan* fell short of achieving basic financial management accountability and control and did not position DOD to adopt financial management best practices in the future.

Although the 1999 improvement plan includes more detailed information on the department's hundreds of improvement initiatives, the fundamental

[73] *Financial Management: Analysis of DOD's First Biennial Financial Management Improvement Plan* (GAO/AIMD-99-44, Jan. 29, 1999).

challenges we highlighted last year remain. Specifically, a significant effort will be needed to ensure that future plans address (1) how financial management operations will effectively support not only financial reporting but also asset accountability and control, (2) how financial management ties to budget formulation, (3) how the planned and ongoing improvement initiatives will result in the target financial management environment, and (4) how feeder systems' data integrity will be improved—an acknowledged major deficiency in the current environment.

For example, to effectively support accountability and control, DOD's plan needs to define each of its business processes and discuss the interrelationships among the functional areas and related systems. To illustrate, the plan should address the entire business process for property from acquisition to disposal and the interrelationships among the functional areas of acquisition, property management, and property accounting.

The department recently announced its intent to develop a "Y2K like" approach for tracking and reporting the CFO compliance of its financial management systems, including critical feeder systems. However, the department currently has hundreds of individual initiatives aimed at improving financial management, many of which were begun prior to the decision that a Year 2000 approach would be used for financial management reform. These decentralized, individual efforts must now be brought under the disciplined structure envisioned by the Clinger-Cohen Act and used previously during the department's Year 2000 effort. Doing so will ensure that further investments in these initiatives will be consistent with Clinger-Cohen Act investment criteria and that the department's financial management reform efforts focus on entire business processes and needed process improvements.

Because of the extraordinarily short time frames involved for the Year 2000 effort, the department rarely had the opportunity to evaluate alternatives such as eliminating systems and reengineering related processes. DOD has established a goal of September 30, 2003, for completing its financial management systems improvement effort. This time frame provides a greater opportunity to consider all available alternatives, including reengineering business processes in conjunction with the implementation of new technology, which was envisioned by the Clinger-Cohen Act.

Strong Department-Level Leadership

Lessons learned from the Year 2000 effort and from our survey of leading financial management organizations also stressed the importance of strong leadership from top leaders. Both these efforts pointed to the critical role of strong leadership in making any goal—such as financial management and systems improvements—an entitywide priority. As we have testified many times before, strong, sustained executive leadership is critical to changing the culture and successfully reforming financial management at DOD. Although it is the responsibility of the DOD Comptroller, under the CFO Act, to establish the mission and vision for the future of DOD financial management, the department has learned through its Year 2000 effort that major initiatives that cut across DOD components must have the leadership of the Secretary and Deputy Secretary of Defense to succeed. In addition, our best practices work has shown that chief executives similarly need to periodically assess investments in major projects in order to prioritize projects and make sound funding decisions.

Improving DOD financial management is a managerial, as well as technical, challenge. The personal involvement of the Deputy Secretary played an important role in building entitywide support for Year 2000 initiatives by linking these improvements to the warfighting mission. To energize DOD, the Secretary of Defense directed the DOD leadership to treat Year 2000 as a readiness issue. This turning point ensured that all DOD components understood the need for cooperation to achieve success in preparing for Year 2000 and it galvanized preparedness efforts.

Similarly, to gain DOD-wide support for financial management systems initiatives, DOD's top leadership must link the improvement of financial management to DOD's mission. For example, DOD stated in its Defense Reform Initiative that improved business practices will eventually provide a major source of funding for weapon system modernization. This can occur through reductions in the cost of performing these activities as well as through efficiencies gained through better information. To ensure that this mission objective is realized will require top leadership involvement to reinforce the relationship between good financial management and improved mission performance. To build this support across the organization, many leading organizations have developed education programs that provide financial managers a better understanding of the business problems and nonfinancial managers an appreciation of the value of financial information to improved decision-making. As discussed below, DOD is taking these first steps in providing training to its financial personnel, and DOD officials have recently stated that their next annual financial management improvement plan will begin to address the need for financial management training for nonfinancial managers.

Strategic Human Capital Investment Integral to Reform

An integral part of financial and information management is building, maintaining, and marshaling the human capital needed to achieve results. While DOD has several initiatives underway directed at improving the competencies and professionalism of its financial management workforce, it has not yet embraced a strategic approach to improving its financial management human capital. Our recently issued guide on the results of our survey of the best practices of recognized world-class financial management organizations shows that a strategic approach to human capital is essential to reaching and maintaining maximum performance.

DOD's 1999 *Financial Management Improvement Plan* recognized the key role of financial management training in ensuring that the department has a qualified and competent workforce. The DOD Comptroller recently issued a memorandum to the department's financial management community emphasizing the importance of professional training and certification in helping to ensure that its financial managers are well-qualified professionals. Consistent with this recent emphasis, the department has begun several initiatives aimed at improving the professionalism of its financial management workforce. For example, DFAS contracted to have government financial manager training developed by the Association of Government Accountants provided to several thousand of its employees over the next 5 years. This training is aimed at enhancing participants' knowledge of financial management and can then be used to prepare for a standardized exam to obtain a professional certification, such as the Certified Government Financial Manager (CGFM)[74]—a designation being encouraged by DOD management.

In another initiative, undertaken in conjunction with the American Society of Military Comptrollers, the department reports that it expects to have its own examination-based certification program for a defense financial manager in place in the near future. The department has contracted with the USDA Graduate School—a continuing education institution—to provide financial management training to an estimated 2,000 DOD financial personnel in fiscal year 2000 and thousands more over the next 5 years. The department reports that this training will be directed at helping participants to develop sufficient knowledge so that they can demonstrate competencies in governmentwide accounting and financial management systems requirements as they are applied in the DOD financial management environment.

[74] The Certified Government Financial Manager (CGFM) is a government financial manager professional certification awarded by the Association of Government Accountants.

The department is faced with a considerable challenge if it is to improve its financial management human capital to the performance-based level of financial management personnel operating as partners in the management of world-class organizations. While DOD's financial personnel are now struggling to effectively carry out day-to-day transaction processing, personnel in world-class financial management organizations are providing analysis and insight about the financial implications of program decisions and the impact of those decisions on agency performance goals and objectives. To help agencies better implement performance-based management, we have identified common principles that underlie the human capital strategies and practices of leading private sector organizations.[75] Further, we have issued a human capital self-assessment checklist for agency leaders to use in taking practical steps to improve their human capital practices.[76]

In closing, as we have noted throughout this testimony, DOD continues to make incremental improvements to its financial management systems and operations. At the same time, the department has a long way to go to address the remaining problems. Overhauling DOD's financial systems, processes, and controls and ensuring that personnel throughout the department share the common goal of improving DOD financial management, will require sustained commitment from the highest levels of DOD leadership—a commitment that must extend to the next administration.

Mr. Chairman, this concludes my statement. We will be glad to answer any questions you or the other Members of the Subcommittee may have at this time.

(919504)

[75] *Human Capital: Key Principles From Nine Private Sector Organizations* (GAO/GGD-00-28, Jan. 31, 2000).

[76] *Human Capital: A Self-Assessment Checklist for Agency Leaders* (GAO/GGD-99-179, Sept. 1999).

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Mr. HORN. As usual, we have had some excellent presentations so far, and we now move to the honorable William J. Lynn, Under Secretary of Defense Comptroller and Chief Financial Officer of the Department of Defense. He's accompanied by Nelson Toye, Deputy Chief Financial Officer. So Mr. Lynn.

STATEMENT OF WILLIAM J. LYNN, UNDER SECRETARY OF DEFENSE (COMPTROLLER), CHIEF FINANCIAL OFFICER, DEPARTMENT OF DEFENSE, ACCOMPANIED BY NELSON E. TOYE, DEPUTY CHIEF FINANCIAL OFFICER

Mr. LYNN. Thank you very much, Mr. Chairman, members of the subcommittee. Mr. Chairman, I do welcome the opportunity to be here today to discuss the financial management of the Department of Defense. As you already entered my formal written statement into the record, I'll just cover a few of the high points in my opening statement as you requested and then turn to your questions.

About a year ago I appeared before this subcommittee to discuss the Department's financial management initiatives. I said then and repeat now that financial management reform continues to be a high priority for the Department's senior leaders. As the Department's Chief Financial Officer, financial management reform is my highest priority. I remain encouraged by our substantial progress and in particular by the commitment of the people advancing that progress, but as has been pointed out here today by the other witnesses, we have much left to do.

Today what I'd like to do is give you a status report on our major initiatives and highlighted challenges ahead. While the Department has had many notable successes in its financial management reform, the reality is that it's impossible to overhaul our financial management operations overnight. The plan reforms will require years to fully implement and require a sustained commitment over not just this administration but future administrations. Nonetheless and though much remains to be done, we are making progress.

Let me divide financial management reform of the Department into thee major phases. The first phase is to consolidate our financial management operations. That phase is complete. We have consolidated over 300 finance and accounting field sites scattered throughout the world into 26 locations. That in itself has produced financial savings over $120 million annually. More importantly, this organizational consolidation has enabled the second phase of financial management reform, the elimination of incompatible and not compliant financial systems.

This phase two is well under way. The number of non-compliant finance and accounting systems has been significantly reduced. In 1991, we had 324 finance and accounting systems. None of them met today's requirements. Today we are down to 96 and by 2003, we expect to have about 30 finance and accounting systems overall a 90 percent reduction, and we expect all of those finance and accounting systems to be compliant with current accounting standards. If we succeed at that, Mr. Chairman, we will have brought DOD from very low standard in terms of other commercial style entities up to the head of the class in terms of the number and the compliance of its finance and accounting. We're about two-thirds of the way there, and we intend to finish it.

The third phase: We've recently initiated this phase which is to upgrade the interfaces with functional systems that feed data into finance and accounting reports. More than 80 percent of the data on DOD's financial statement comes from outside the finance and accounting network. The data comes from personnel, from acquisition, from logistics, from medical, and other systems. It has to be inputted into the finance and accounting systems to provide the finance and accounting or provide the accounting reports that are necessary to produce audited financial statements and to produce the kind of management information that's needed to oversee the Department.

Establishing a seamless connection between these so-called feeder systems and the accounting systems used to prepare financial statements is the crucial final step in financial management reform. These feeder systems were developed and put into service well before the promulgation of Federal accounting standards. They simply were not designed to produce business-style financial statements. Accordingly, much of our financial information has to be manually transfered from these systems into the accountant system. Indeed, some of the information that the auditors insist upon is simply not available within those systems at all and therefore has to be estimated in some way.

The systems just don't produce the information. Let me give you an example. Our inventory systems primarily are designed to maintain records on the latest acquisition costs. This is the data the logistic managers find most critical. The systems do not retain, in most, cases the historical costs of items, which is the data that the auditors want for their financial statements—for our financial statements. We are moving to upgrade our inventory systems to retain both historical and latest acquisition costs, so that single inventory system will produce both the data needed to manage the logistic system as well as to produce the finance and accounting statements, but this is an expensive and laborious process. It is going to take several years.

The third phase of this—of financial management reform is going to extend well beyond the financial arena. It touches nearly every other function of the Department. To oversee this massive effort, we've accepted the recommendation of both the GAO and the IG that we establish a Y2K-like process run by a panel. The panel will report to the Deputy Secretary through the defense management counsel and the panel will as in the Y2K effort establish milestones, review progress, and monitor implementation to move the 70 or so critical feeder systems into compliance with current accounting standards.

In order to accomplish the fundamental financial management reform that we have in mind, we will have to complete this effort to establish the interfaces with all these critical feeder systems. This will take several years and substantial new resources. In the interim, however, we believe we can make substantial progress toward earning an unqualified audit opinion for the Department.

Toward that end, we've collaborated the organizations and individuals represented at this table to identify major obstacles that must be overcome for the Department to be successful. We have developed interim solutions to systemic problems, and we are applying accounting and auditing standards in ways that make sense for the Department of Defense. Major deficiencies that have prevented us from receiving a favorable audit opinion in the past have been identified; strategies to deal with those deficiencies have been developed and are being coordinated with my colleagues at this table today. Details of those strategies are discussed at some length in my written statement for the record. I'm happy to go into further detail on any questions you might have.

Let me close, Mr. Chairman, by saying that during my tenure as the Department's Chief Financial Officer, I witnessed substantial progress and an extraordinary transformation of our financial activities as well as other financial areas with which those activities must interact. This progress reflects a collective effort spanning both the financial and the non-financial communities.

I want to publicly acknowledge and offer my sincere thanks to my staff as well as the staff element also of the other principles within the office of the Secretary of Defense, the Defense Accounting Service, the military departments and the defense agencies for their hard work and for their dedication.

In sum, we have built a strong financial management reform foundation upon which those that follow us can build. We remain determined to have financial management reform so well advanced by the time the next DOD leadership team takes over, that it will conclude that completing the job is not only wise and necessary but achievable.

Our DOD leadership team also has been determined to keep foremost in our minds that the Department's primary mission is national security. Our reforms must support that mission, not burden the troops and support activity who fulfill it.

We've been asked by Congress and the audit community to do things not previously required of the Department. Our challenge is to design such new procedures so that they enhance, not diminish the Department's management and leadership and the accomplishment. Its overall mission. In closing, Mr. Chairman, I would like to thank you and the subcommittee for this opportunity to discuss financial management reform within the Department. I'm happy to answer your questions.

[The prepared statement of Mr. Lynn follows:]

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STATEMENT OF THE HONORABLE WILLIAM J. LYNN

UNDER SECRETARY OF DEFENSE (COMPTROLLER)
CHIEF FINANCIAL OFFICER

DEPARTMENT OF DEFENSE

BEFORE THE

COMMITTEE ON GOVERNMENT REFORM

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

ON

FINANCIAL MANAGEMENT WITHIN THE DEPARTMENT OF DEFENSE

May 9, 2000

For Official Use Only
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House Government
Reform Committee

Statement of the Honorable William J. Lynn
Department of Defense
Under Secretary of Defense (Comptroller)/Chief Financial Officer
Before the House Government Reform Committee
Subcommittee on Government Management, Information, and Technology

Mr. Chairman and Members of the Subcommittee, it is a pleasure to be here today to discuss financial management within the Department of Defense.

I want to begin by stating that I am here today for two important reasons. First, I want to assure the Congress and the American taxpayers that the Department of Defense is a good steward of the resources that they have entrusted to the Department. Second, many may not be aware of the comprehensive financial management reforms currently underway within the Department. Thus, I would like to highlight some of the major initiatives that are enhancing financial management throughout the Department while, at the same time, are supporting our forces at a high level of readiness and effectiveness.

FINANCIAL MANAGEMENT REFORM

About a year ago, I appeared before this Subcommittee to discuss the Department's financial management initiatives. I said then, and I want to say at the outset now, that financial management reform within the Department of Defense continues to be a very high priority. As we move into the 21st century, and chart a new financial management millenium, the Department's senior leaders remain committed to improving financial management. As the Chief Financial Officer for the Department, this continues to be one of my highest priorities as well, and I remain encouraged by the commitment of the Department's personnel engaged in these improvement efforts.

Reflecting the resolve of the Department's senior leaders, the Department continues to pursue the most comprehensive reform of financial management systems and practices in the Department's history. Progress to date has been substantial, and the Department is determined to successfully complete this historically significant reform effort.

The Department's pivotal agent for accomplishing needed financial management reforms is the Defense Finance and Accounting Service (DFAS). The DFAS has made remarkable progress since its formation in 1991. Prior to the establishment of the DFAS, the Department compiled finance and accounting information through a series of vertical operations and organizations--information traveled up stove pipes but not across communities. Each Component had different processes and systems for its financial management, logistics, acquisition, and personnel activities. These processes and systems often did not share common data and could not effectively communicate with each other. Additionally, the processes and systems were not sufficiently flexible to respond rapidly to changing requirements.

When the Department of Defense Components turned over their finance and accounting operations to the DFAS in 1991, they also turned over numerous problems. In response to these many problems, the Department undertook the most comprehensive reform of financial management systems and practices in the Department's history. Since 1991, financial operations have been consolidated, the number of noncompliant finance and accounting systems have been significantly reduced, standard systems have been designated, ambitious deployment schedules have been established and implemented, and business practices have been reengineered to adopt best practices from both the private and government sectors.

Consolidation of Financial Management Operations

The DFAS has consolidated over 300 finance and accounting field sites scattered throughout the world into 26 locations, saving $120 million annually. Through these consolidations, the Department has been able to eliminate redundancy and unnecessary management layers, facilitate standardization, improve the accuracy and timeliness of financial operations, enhance service to customers, increase productivity, and provide better financial management support to the Department's decision-makers. In short, the DFAS has taken what was a number of widely disbursed, costly and less effective nonstandard accounting operations and merged them into a smaller, more efficient and more effective operation. And it accomplished this goal almost 2 years ahead of schedule.

Consolidation of Finance and Accounting Systems

To remedy the problem of numerous, incompatible and noncompliant finance and accounting systems the DFAS inherited from the Department's Components, the DFAS embarked on a major effort to streamline financial systems. As of March 2000, 96 finance and accounting systems were operating--down from 324 systems in 1991, a 70-percent reduction. Finance systems have been reduced from 127 to 15, with a goal of dropping to just nine by 2003. Accounting systems are down from 197 to 81, with a goal of 22 or fewer by 2003. By the year 2003, the Department expects to account for and pay over 2 million service members, 2.2 million retirees and annuitants, over 700,000 civilian employees, and 200,000 contractors using just 31 finance and accounting systems--a 90-percent reduction.

These consolidations have achieved genuine benefits and savings. For example, in bringing into a single system all of the Department's 700,000 civilian payroll accounts, 26 separate systems were eliminated and 348 payroll offices closed. In 1999, a typical civilian payroll technician handled over 2,100 accounts, compared to just 380 accounts in 1991.

The objective of the Department's initiative, however, is not simply to reduce the number of financial management systems. The consolidation, standardization, and modernization of the Department's financial management systems is intended to enable the Department to eliminate its outdated noncompliant financial management systems and substantially meet federal financial management system requirements, adhere to new applicable federal accounting standards, and use the United States Government Standard General Ledger at the transaction level. These efforts also are producing more accurate, timely, and meaningful financial management information for decision-makers.

Efficiencies

As a result of a number of initiatives, the DFAS has significantly reduced its personnel requirements and its operational costs, creating more efficient and economical operations while improving services provided to its customers.

Between FY 1993 and FY 1999, personnel levels that the DFAS inherited from the Department's Components decreased by 37 percent, from 31,000 personnel in FY 1993, to 19,500 personnel at the end of FY 1999. By FY 2003, the Department projects that DFAS personnel levels will decrease by another 2,000 personnel, to 17,500. Thus, over the 10-year period from FY 1993 to FY 2003, the DFAS will have achieved a 44-percent reduction in its personnel levels.

In FY 2000 constant dollars, the DFAS cost of operations has decreased from approximately $2.0 billion in FY 1995 to $1.7 billion in FY 1999--a 15-percent reduction. These savings in operating costs have been achieved despite the assumption of additional missions. Admittedly, these savings are being offset, in part, by the need to invest in new systems and technology in order to meet today's new requirements and tomorrow's challenges. However, when compared to the operations of the Department as a whole, the DFAS budget equates to approximately six-tenths of one percent of the Department's budget. This is about one-half the private industry average of 1.2 percent.

Public-Private Partnerships

The Department has successfully used competition within the government and with the private sector to improve support services and save money. The Department recognizes that many finance and accounting functions can be competed without posing a significant risk to the Department's operations. The DFAS has recognized that approximately 85 percent of its personnel perform functions that might be eligible to be outsourced on a competitive basis. To date, approximately one-third of the DFAS operations, measured in terms of costs, either have been outsourced, competed for outsourcing, or are in the process of an outsourcing competition. In addition, the DFAS has committed to study over 6,000 positions during the next 5 years.

Changes implemented by the DFAS, as a result of competition studies, already have produced annual savings of $36.9 million through the streamlining of administration operations, facilities, and logistics; vendor payments; transportation accounting; depot maintenance accounting; and by consolidating debt and claims management. Within the financial community, the Department is using public-private competition--the A-76 process--to improve functions in other areas such as civilian and retiree/annuitant payroll and security assistance accounting.

Financial Management Policies

The Department has replaced approximately 30,000 pages of separate, and sometimes conflicting, Defense organizational financial management regulations, policies, and procedures with a single standard "Department of Defense Financial Management Regulation"

("DoDFMR"). In order to ensure the widest possible distribution of the policies contained in the "DoDFMR," the "DoDFMR" has been made available on the Internet and on CD-ROM.

In January 2000, the Department began to review the approximately 40,000 remaining pages of financial management policy and procedures still in publication within the Department's Components. This effort is expected to result in the elimination, or merging into the "DoDFMR," of many of those policies and procedures and create a single source of consistent financial management guidance for use throughout the Department.

Internal Controls and Fraud Detection

To strengthen internal controls and elevate fraud awareness, the Department has implemented, and continues to implement, additional checks, balances, and approval requirements for transactions. Such internal controls minimize the Department's susceptibility to fraud, waste and abuse within its finance and accounting operations. In implementing adequate internal controls, the Department strives to incorporate appropriate levels of verification without requiring excessive resources or hampering the Department's ability to complete the mission. The DFAS and other Department of Defense organizations also continue to implement information assurance programs and fraud detection and protection measures. Some of the more significant internal control efforts include:

- Creating a centralized Fraud and Internal Review Office within the DFAS to better ensure that programs achieve intended results, laws and regulations are obeyed, resources are appropriate for a program's mission, data is reliable, and fraud is prevented;

- Enacting a 100-percent review of the Department's vendor pay systems to determine who has access and at what levels, and ensuring that the necessary separation of duties exists;

- Implementing an employee internal control responsibility training program;

- Strengthening in-house reviews to detect improper alterations of receiving reports; and

- Enhancing fraud awareness and prevention training for vendor pay employees.

Operation Mongoose

Another internal control initiative was the creation of Operation Mongoose to identify potential erroneous, duplicative, or fraudulent payments, and to detect and correct potential internal control weaknesses. This initiative uses the combined efforts of the DFAS, the Defense Manpower Data Center, and the Department of Defense's Inspector General's Office, including the Defense Criminal Investigative Service, to develop fraud indicators that can be spotted by discrepancies between systems. This program collects and compares data throughout the

Department, detects the presence of anomalies within the Department's systems and refers these anomalies to appropriate Department organizations for further review or investigation. If fraud is found, the Department vigorously pursues criminal charges against those who are responsible for the fraud. The objective of Operation Mongoose is to establish a permanent structure to detect and prevent fraud by reducing the opportunity for the concealment of crimes and actively seeking it out, rather than waiting for it to surface by chance, be identified by informants, or be detected by random reviews. Despite isolated occurrences, the Department is succeeding in firmly closing the door on fraud.

Improving Accounting for Disbursements

Nearly all of the Department's payments are matched to recorded obligations at the time the payment is made or shortly thereafter. A small percentage of payments, however, require additional time and research to ensure that the transactions are recorded correctly in the Department's accounting records. This additional effort is required because, within the Department, separate offices and separate automated systems often are used to record the obligation of purchases in the accounting records, compute payment entitlements (i.e., determine how much should be paid and when), disburse funds (i.e., make payments), and then record the payment in the accounting system.

This separation of duties reflects good internal controls. However, because the applicable entitlement, payment, and accounting systems are not fully integrated, some of the data required to process these transactions must be input manually into the Department's automated systems. This creates the potential for "unmatched" transactions as data flows between the different systems involved. For example, simple keystroke errors may occur during the process of manually inputting the same data into different systems. Such errors can result in data not matching when comparable information subsequently is transmitted between systems.

These disbursement matching problems have been reduced by over 80 percent in recent years. Although the Department considers this problem a matter to be taken seriously, almost all such expenditures connected with these disbursements were made only after a Department official confirmed that the goods or services were received and that the payment was in accordance with a valid contract.

Prevalidation, the procedure of matching a disbursement to an obligation before (rather than after) a payment is made, has helped to significantly reduce accounting problems associated with disbursements. Thresholds for applying prevalidation are gradually being lowered until virtually all payments will be prevalidated.

In addition to prevalidation, the Department also is implementing a system called the Defense Cash Accountability System (DCAS), through which disbursement voucher data is collected electronically under one central standard system and distributed electronically for posting to accounting systems. DCAS is expected to reduce the Department's accounting cycle for disbursements from over 90 days to approximately 48 hours.

Information Infrastructure

The DFAS Corporate Information Infrastructure (DCII) is being implemented to help modernize DFAS finance and accounting systems and to establish the information environment needed to better support future financial activities. DCII will support the use of common standard data for the collection, storage, and retrieval of financial information. It also will simplify and standardize the Department's finance and accounting transactions. Included in DCII is an ambitious effort to standardize and share acquisition data. This will greatly improve the interactions between the Department's procurement systems and the financial systems that process and account for payments for the Department's procurements.

Electronic Exchange of Financial Information

The DFAS also is promoting the paperless exchange of financial information through a variety of other initiatives. One of the primary benefits of these initiatives is the elimination of manual processing of various documents and, thereby, significantly increasing the accuracy and timeliness of information. Another primary benefit is a reduction in the cost of processing data. Some examples of these initiatives include:

- Electronic Document Management (EDM) and World Wide Web applications. EDM and World Wide Web applications are enabling on-line, real-time access to documents needed to perform bill paying and accounting operations. Under this process, contracts, bills of lading, and payment vouchers can be stored in an electronic file and shared among DFAS activities. Another application eliminates the printing of reports by converting them into an electronic format for on-line analysis, reconciliation, and reporting. EDM technology also is being used to enhance the control and management of documents needed for bill paying operations, regardless of the format of the document, as well as to link to the Department's pay systems.
- Electronic Funds Transfer (EFT). EFT is being used to reduce the cost and improve the accuracy and timeliness of disbursements. Over 98 percent of the Department's civilian and military employees have their pay directly deposited into their personal bank accounts. The direct deposit participation rate for travel payments is now over 90 percent. In 1999, EFT accounted for about 90 percent of the total contract dollars disbursed by the Department.
- Electronic Data Interchange (EDI). The DFAS is using EDI to send remittance information directly to vendors and currently is processing EDI contracts and contract modifications into finance and accounting systems. The DFAS also is implementing a web-based invoicing system that provides industry with an economical method to submit electronic invoices.
- Web-based Central Contractor Registration (CCR). Through its Joint Electronic Commerce Program Office, the Department has fielded a web-based CCR program that provides our procurement and payment offices with a single source of valid and reliable contractor data. The CCR capability also helps the DFAS capture up-front contractor financial data that facilitates EDI and EFT payments.

Financial Management Improvement Plan

The Department's long-term strategy recognizes that lasting effective financial management reforms require a Defense-wide management information overhaul. The long-term strategy is, through reengineering or replacement, to ensure that both the Department's financial and feeder systems can implement new federal accounting standards and that they are effectively interfaced or integrated. (Feeder systems are systems that support both financial management and other functions and pass, or "feed" information to accounting systems. For example, an inventory system may provide inventory managers information about the type, quantity and location of inventory while also "feeding" financial information to accounting systems for use in the preparation of financial reports and/or statements.)

The Department has developed a comprehensive plan--the Financial Management Improvement Plan--to address planned changes to financial management operations. In October 1998, the Department submitted its first Financial Management Improvement Plan to the Congress. The Department updated the Plan in 1999 and intends to continue to update the Plan on an annual basis.

In the Plan, the Department identifies its long-term strategy for improving its financial management operations, to include addressing various initiatives intended to reform the Department's financial management practices and systems. The Plan discusses the current financial management environment within the Department, addresses the Department's financial management concept of operations for the future and identifies the Department's proposed approach for transitioning to the future concept of operations.

The Plan also summarizes and highlights the substantial progress the Department has made in improving its financial management operations to date. In addition, it presents information on the Department's systems--including the compliance status of systems, their noted deficiencies, proposed corrective actions with milestones, and a graphical representation of system interfaces. Details on policy and infrastructure initiatives also are provided. The Plan may be found at http://www.dtic.mil/comptroller/99FMIP/ on the Internet.

Y2K-Like Process for Achieving Systems Compliancy

To aid in improving and/or replacing the Department's financial and feeder systems, the Department is initiating a "Y2K-like Process." Similar to the efforts associated with the potential January 1, 2000 computer problems, this "Process" provides for overseeing and monitoring progress on actions needed to better ensure that both financial and feeder systems meet federal financial management requirements. The "Process" consists of five phases with defined exit criteria and a governing body to provide oversight and guidance.

The five phases of the process are awareness, evaluation, renovation, validation and compliance. The awareness phase includes identifying the Department's financial and feeder systems and then determining which of the systems are "critical" to financial management. This phase mostly has been completed. The evaluation phase includes identifying specific deficiencies and developing corrective action plans. The renovation phase involves implementing needed corrective actions and bringing the systems into compliance. During the validation phase, confirmation is obtained from an independent third party that the system is compliant with federal financial management systems and other applicable requirements.

As the Under Secretary of Defense (Comptroller), I will chair the governing body which will provide oversight and guidance to the Military Departments, the Defense Agencies, and the Defense Finance and Accounting Service. While the Military Departments and Defense the Agencies will be responsible for executing the five phases of the "Process" for each of their respective critical systems, they will be required to obtain approval from the governing body for each phase before proceeding to the next phase.

FINANCIAL MANAGEMENT TRAINING AND PROFESSIONAL DEVELOPMENT

The Department's financial management reform initiatives have focused on organizational structure, infrastructure, policies, processes and systems. However, the Department recognizes that sound financial management practices also demand well-trained and well-qualified personnel.

While the Department's current financial management workforce is well-qualified and highly motivated, its future workforce must be even better qualified. Accordingly, the Department needs to better prepare the next generation of its financial management leaders. To that end, an extensive workforce development program is underway within the Department. An agreement with the U.S. Department of Agriculture Graduate School has been reached to present a new 5-day class in 32 locations to over 2,000 Department of Defense financial managers this calendar year. These classes will address financial management challenges that face the Department of Defense. This training is intended to better ensure that the Department's personnel "know the rules" that affect the administration of the Department's funds. The Department intends to continue presentation of these classes to over 2,000 Department of Defense financial managers in each of the next 5 years, and beyond.

The Department's financial management senior leaders also are encouraging members of their financial management community to obtain appropriate professional certifications such as those of a Certified Public Accountant, Certified Government Financial Manager, Certified Internal Auditor, Certified Cash Manager, and other appropriate certifications. In addition to demonstrating professional competency, such professional certifications often impose a continuing education or training requirement to better ensure that once certified, the individual remains current with changes in financial management requirements and retains their proficiency.

In addition, and in cooperation with the American Society of Military Comptrollers, the Department has initiated a new Certified Defense Financial Manager (CDFM) Program specifically geared toward Defense financial managers. The Department believes there is a benefit to having a Defense certification program because of the complexity of the Defense budget and its appropriations; the Defense Planning, Programming, and Budgeting System; the

Department's accounting procedures; and related financial management policies and procedures. Eligibility requirements for the CDFM include a minimum of 3 years of relevant Defense financial management experience, or 2 years of relevant Defense financial management experience with an Associate or higher degree. Similar to other certification programs, the CDFM is a test-based program. Additionally, once certification is obtained, an individual must continue their professional education/training in order to retain their certification.

The pursuit of desired professional standards for the Department's financial management workforce should help to better ensure that the Department can continue to produce high quality financial managers. It also should demonstrate the desired level of knowledge and capability of the Department's financial managers in an objective and measurable manner that is visible to the Department's leaders, the Congress and to the American public. In short, greater attention to professional training and development is good, not only for the Department's financial management community, but also for the Department as a whole.

Employees outside of the Department's financial management community also must be, and are being, given appropriate financial management training. Senior leadership and management training courses, such as the Services' War Colleges, the National War College, and the Industrial College of the Armed Forces, all have incorporated financial management modules into their curriculums. In addition, many of the Department's courses for mid-level leaders and managers, such as the Command and General Staff Colleges and the Army Management Staff College, include financial management modules as well.

The Defense Acquisition Workforce Improvement Act mandates training and certification of all of the Department's employees who serve in acquisition workforce designated positions. The training required for certification in some acquisition subspecialties includes elements of budget formulation, justification and execution; accounting and auditing principles; internal controls; and other financial management principals. As the Under Secretary of Defense (Comptroller), I am represented on the board that develops and periodically reviews and updates the training requirements for this career field, as well as assists in the oversight of courses and the quality of instruction.

Additionally, the Department is in the process of developing training for its property managers and logisticians. This training not only is intended to reinforce accountability requirements, but also to emphasize financial management requirements to such personnel. The training is intended to instruct property managers and logisticians on how their management responsibilities impact the Department's efforts to accurately record and report property acquisition costs, acquisition and disposal dates, and depreciation. Property accountability modules within these training courses are intended to inform property managers and logisticians of the mandatory requirements for conducting physical inventories, the documentation requirements for such inventories, and the actions necessary to correct property accountability records and systems to reflect the results of physical inventories.

AUDITED FINANCIAL STATEMENTS

With the passage of the Chief Financial Officers Act, the Government Management Reform Act, the Federal Financial Management Improvement Act and new federal-wide accounting standards promulgated by the Federal Accounting Standards Advisory Board, the federal government has been playing catch-up to comply with many new requirements to produce business-type auditable financial statements. The Department of Defense is no exception. It, too, is striving to comply with new statutory and other requirements.

The Department previously has acknowledged that its financial and feeder systems were not designed to produce business-type financial statements. Quite the contrary. The Department's financial management systems were designed to perform budgetary accounting for the resources appropriated to the Department by the Congress. The Department's feeder systems, which generate the preponderance of business transactions within the Department, were designed to provide accountability over the Department's assets and perform other functions. These financial and feeder systems satisfactorily perform the missions that they were designed to perform. However, because these systems were not designed to provide financial information for business-type financial statements, it is not surprising that these systems do not do a good job of producing business-type financial statements that, until recently, the Department was not required to prepare. Nor should the difficulty in producing data for financial statements be misconstrued to mean that the Department does not do a good job of carrying out its stewardship and fiduciary responsibilities. In fact, the Department does a very good job.

Most of the Department's financial and feeder systems were designed prior to the promulgation of new federal accounting standards. Information from these systems often is not collected in a way that complies with new federal accounting standards. Other information needed to meet some of the new reporting requirements is not collected in the Department's automated systems at all. Therefore, such information is manually entered into the accounting system at the end of the applicable fiscal year in order to facilitate the preparation of business-type financial statements. Although the use of estimates and the manual entry of data into accounting systems are acceptable practices, the Department is aggressively engaged in modernizing its financial and feeder systems and developing automated interfaces between its systems--both to minimize the use of estimates and to avoid the need to manually enter information. Thus, one challenge for the Department is to modernize both its financial and feeder systems to produce business-like financial statements.

STRATEGIES FOR OBTAINING FAVORABLE AUDIT OPINIONS

While system changes are the long-term solution, there is much that the Department can, and must, do now. Our short-term strategy recognizes that. We are developing interim methodologies that will aid the Department in achieving more acceptable results and will be sufficient to support more favorable audit opinions on the Department's financial statements.

To succeed in this effort, the Department has fully engaged in a partnership with the Office of Management and Budget (OMB), the General Accounting Office (GAO) and the Office of the Inspector General (OIG) for the Department of Defense. We have worked, on a collaborative basis, to identify major obstacles that must be overcome for the Department to be successful; to develop interim solutions to the Department's systemic problems; and to apply accounting and auditing standards in ways that make sense for the Department of Defense.

Major deficiencies that prevented the Department from receiving a favorable audit opinion in the past have been identified. Alternative methodologies to deal with these deficiencies have been developed and coordinated with the OMB, GAO, and OIG. To implement these alternatives, plans detailing short-term strategies for solutions to each of the deficiencies have been developed along with the identification of responsible parties and milestone dates needed to support accomplishment of the Department's goal. To better ensure that we stay on track, applicable organizations within the Department are being asked to report on their progress and, as appropriate, update their plans.

Each of the implementation strategies is intended to address specific deficiencies previously noted by the audit community. When fully implemented, these implementation strategies are expected to allow the Department to attain a more favorable audit opinion on the Department's financial statements. Examples of some of the Department's more significant short-term implementation strategies include, but are not limited to, the following:

Valuation of General Property, Plant and Equipment (PP&E)

Recently approved accounting standards require PP&E to be reported at acquisition (i.e., historical) cost and depreciated. To validate the original costs, auditors want to see the original receipt or purchase document. However, the federal government's record retention policies are not consistent with such audit requirements.

For example, the National Archives and Records Administration requires that most financial management documents and records be retained only for 6 years and 3 months. When the auditors attempt to audit assets that are older than 6 years and 3 months, they have difficulty finding documentation to support the reported values because the activities typically do not maintain documentation beyond the required retention period. This does not mean that the values reported by the Department are incorrect, rather it means that the auditors cannot verify the values reported.

To address this situation, the Department engaged two of the largest and most prestigious public accounting firms in the world to provide a value for the Department's property that would be acceptable to the Department's auditors. Recently, the public accounting firm assessing the value of the Department's real property indicated that the values recorded by the Department were materially accurate for the Department's real property. The Department has not yet reached a similar milestone relative to its personal property. However, the Department continues to work with the contractor and the audit community in the pursuit of attaining a similar goal.

Additionally, because the Department's accounting systems were not designed to capture, retain and depreciate the costs of PP&E assets, the Department is working with the audit community, and has asked public accounting firms to assist, in the development of guidance, processes and other changes needed to resolve existing systems deficiencies. This is an enormous undertaking for the Department because of the tremendous number of PP&E assets that the Department owns worldwide.

Accounting for the Department's Military Equipment

The Department has an estimated $600 billion invested in, and spends significant amounts of funds annually for, military equipment. The Federal Accounting Standards Advisory Board (FASAB) has yet to determine the desired permanent accounting and reporting requirements for the Department's military equipment--which the FASAB refers to as National Defense Property, Plant and Equipment (PP&E). Obviously, once the FASAB issues its permanent accounting standard for National Defense PP&E, the standard will have a major impact on the Department's financial management processes. The FASAB is considering several accounting and reporting alternatives. This issue is a very complex matter and can be expected to have a major impact, not only on the Department of Defense's financial statements, but, potentially, also on the consolidated government-wide financial statements.

Recently, the Department hired a contractor to perform a detailed and thorough analysis of each of the accounting and reporting alternatives being considered by the FASAB. The FASAB has agreed to consider, as part of its deliberations, such appropriate analysis as the contractor may complete, as well as other relevant information that the contractor may provide.

The contractor--a well respected national Certified Public Accounting firm--will: (1) identify pros and cons of each alternative being considered, (2) provide an estimate of the costs for implementing each alternative, and (3) recommend timeframes for implementing each alternative. The Department will closely monitor the deliberations of the FASAB. Ideally, the FASAB will issue an accounting and reporting standard that meets the needs of external users of the Department's financial statements, is compatible with the manner in which the Department does business and supports internal decision-makers that might use such financial information.

Valuation of Inventory

Similar to PP&E, the new accounting standards require a valuation of inventory based on historical cost (the amount paid) or latest acquisition cost (a revaluation of all items in stock to equal the amount paid for the last item purchased). When the latest acquisition cost is used, the difference between historical cost and the latest acquisition cost must be reported as an unrealized gain or loss--in effect resulting in latest acquisition cost equating to historical cost.

Inventory values are not contained in the Department's financial systems. Instead, such information is included in logistical (feeder) inventory systems. These systems do an excellent job of ensuring that our troops have the parts they need, when they need them, at the place that they need them, and in the condition required to perform their mission effectively and efficiently. However, the systems were not designed to provide accounting data to support financial statements--which became a requirement only beginning in FY 1998. Nor are the Department's logistics systems sufficiently integrated with the Department's accounting systems to pass, in an automated manner, information that is required by the new federal accounting standards. Additionally, these logistical inventory systems often value inventory at selling price--not historical cost or latest acquisition cost. As a consequence, the dollar value of inventory reported on financial statements is a calculated, vice a system driven, amount. These calculated amounts are determined by using a formula that adjusts the inventory values reported by logistical inventory systems to an approximation of latest acquisition cost and historical cost.

The Department's logistics and financial communities are working together to improve the quality and reliability of the financial inventory amounts that are reported and are actively pursuing process improvements that will better comply with the new accounting standards. As inventory systems are renovated or replaced, new functionality that will better support audited financial statements will be added. In the meantime, the Department is working with its auditors to refine the formula used to calculate inventory values reported on the Department's financial statements, as well as to identify what specific sources of information would be most beneficial for use in such a calculation.

Operating Materials and Supplies

The current accounting standard allows for the use of two accounting treatments for operating materials and supplies--the consumption method and the purchase method. Under the consumption method, operating materials and supplies are recognized as assets when purchased, and are expensed when they are issued to an end user in normal operations. Under the purchase method, operating materials and supplies may be expensed when purchased.

The Department is working in conjunction with the audit community to evaluate when the consumption method should be used and when the purchase method is appropriate, and to define "end users." In those cases where it is determined that the consumption method is appropriate, the systems that would be used by the Department's Components to report operating materials and supplies primarily are logistics systems. These logistics systems were not designed to record and report historical cost, and logistics processes do not require retention of supporting documentation that meets the very stringent audit trail requirements necessary to support preparation of audited annual financial statements. The Department is working to define and develop functional requirements for logistics systems that better support accounting and valuation of operating materials and supplies, and to develop plans to update existing systems. While system changes will be required to institutionalize the automated reporting of accepted values for operating materials and supplies, the Department is working with the audit community to identify process or other changes that can be implemented in the interim to allow applicable values to be reported in a manner acceptable for financial statement purposes.

Environmental Liabilities

Current federal accounting standards require reporting the estimated costs of known and potential future environmental liabilities associated with the Defense Environmental Restoration Program (cleanup from past waste disposal practices at active and closed installations and formerly used defense sites); cleanup of closed, transferred, and transferring training ranges; preservation and management of active and inactive training ranges; and the future disposal of weapons systems (nuclear powered ships and submarines) and chemical munitions. Many of these costs will not be incurred until 20, 30, or even 40 or more years in the future.

The Department reported approximately $34 billion in environmental liabilities for FY 1998. For FY 1999, the amount that was reported was $80 billion. The large increase in environmental liabilities reported for FY 1999 resulted primarily from the inclusion of amounts for future disposal of weapons systems and future efforts associated with the cleanup of training ranges. There also was an increase associated with reporting the estimated disposal cost of chemical munitions.

However, some of the Department's future environmental liabilities have not yet been fully assessed. For example, it is likely that additional environmental liabilities associated with training ranges will be reported in future years. To report these additional amounts, the Department requires additional time to conduct inventories, surveys and site assessments, and to prepare cost estimates.

Military Postretirement Health Benefits and Claims Liabilities

Military postretirement health benefits and claims liabilities are amounts that are estimated to be paid over a period that could be as long as the next 100 years. In reporting an actuarial liability for military postretirement health benefits and claims, historically the Department based its estimate on prior actual obligations. However, the new accounting standard requires that, to be acceptable estimates, these liabilities must be determined through the use of accrued costs instead of obligations.

The Department is enhancing its ability to report such liabilities using factors that are more in accordance with the new accounting standards. The Department, in partnership with the GAO and the OIG, has formed a working group to evaluate the use of various cost data as a means to measure future military postretirement health benefits and claims liabilities. This data will be the baseline used to calculate estimated military postretirement health benefits and claims liabilities for future financial statement reporting purposes.

Fund Balance with Treasury

The Department maintains its own checkbook. Private sector firms that maintain their own checking accounts reconcile the cash balance reported by the bank with the firm's check register. Similarly, cash balances shown on the Department's checkbooks should be reconciled with the cash balances on the books of the U.S. Treasury. In the past, the Department's financial statements reported the amounts provided by the U.S. Treasury instead of the balance reflected in the Department's financial records. Frequently, the account balances at the U.S. Treasury do not agree with the account balances on the Department's financial records. These differences primarily are caused by timing differences that result from (1) separate accounting and reporting systems that are not integrated, or (2) other agencies disbursing on behalf of, and charging such disbursements to, the Department of Defense.

As approved by the OMB, the Department has discontinued reporting the cash balances reported by the Treasury and, instead, effective with its FY 1999 statements, reports the fund balance shown in the Department's "Fund Balance With Treasury" general ledger account. Differences between the amount reported by the Department and the balance in Treasury's account, if any, are reconciled and explained in the footnotes to the financial statements.

IMPORTANCE OF FINANCIAL MANAGEMENT REFORM

Sound financial management information is important for a variety of reasons. And the financial management reforms underway within the Department of Defense embrace that precept.

- Sound financial management practices provide greater visibility over costs. Having timely and accurate cost information aids decision-makers--both internal and external to the Department--in better allocating resources and in making business decisions.

- Sound financial management controls provide safeguards to better ensure that funds are used for intended purposes and to discourage and prevent fraud, waste and abuse.

- Dependable financial operations assure contractors and vendors with whom the Department does business that they will be paid accurately and in a timely manner. In turn, this better ensures goods and services will be available to the Department when and where the goods and services are needed.

- Reliable financial management operations support our troops. It instills confidence in our soldiers, sailors, airmen, marines, and our civilian employees, that their financial entitlements, as well as those of their families, will not be neglected even though they may be thousands of miles from home.

Because sound financial management information is important, financial management reforms within the Department also are important. Reforming financial management practices will allow the Department to obtain better and more timely information to support better informed management decisions. And better management information also can be the foundation for even more reforms in the Department's business practices. Further, financial management reforms can be expected to increase the public's confidence in the Department by demonstrating, to those outside the Department, that the Department is, indeed, a good steward of the resources that the Congress, and the Nation, has entrusted to it.

CONSTRAINTS ON THE PACE OF FINANCIAL MANAGEMENT REFORMS

The Department's financial management reforms were designed to fulfill the financial management information needs of the Department's leaders, meet statutory requirements, and maximize efficiency and minimize fraud. However, these reforms are still a work-in-progress.

While tremendous strides have been made, and there have been many notable successes, progress has been slow in some areas. The reality is, it is impossible to reverse decades-old problems overnight. These reforms will require several years to complete. Further, in pursuing such reforms, the Department has had to recognize, and accommodate, three unavoidable constraints.

Continuation of Diverse, World-Wide Operations

The size, complexity and diversity of the Department's ongoing operations make changes to the Department's financial management processes and systems a significant challenge. The Department manages over a trillion dollars in assets, including weapons systems, and maintains hundreds of bases in over 100 countries and territories throughout the world. It has over two million active duty and reserve component personnel as well as 700,000 civilian employees. The size of the three Military Departments--Army, Navy and Air Force--collectively dwarfs the largest organizations in the private sector as well as all other federal agencies.

There is no other organization in the United States, perhaps in the world, that is as large and diverse as the Department of Defense. The Department operates 100,000 vehicles, from trucks to tanks, maintains a fleet of more than 22,000 aircraft and operates hundreds of oceangoing vessels around the world. Every month, the Department makes 920,000 contract or purchase actions, fits troops with 50,000 pairs of boots and serves 3.4 million meals. On any given day, the Department buys enough fuel to drive a car around the world 13,000 times, maintains 12,000 miles of waterways, operates 550 public utility systems--including 24 percent of the nation's hydropower capacity, manages 232 schools and provides day care for over 200,000 children.

As the largest finance and accounting firm in the world, the Defense Finance and Accounting Service processes a monthly average of nearly 10 million payments to the Department's personnel; processes and pays 1.2 million commercial invoices; settles and pays 450,000 travel vouchers; issues 500,000 savings bonds; processes and pays over 100,000 transportation bills of lading; and makes disbursements averaging approximately $24 billion.

The Department cannot stop its financial operations while it fixes outdated business practices and flawed systems. The daily operating requirements of the Department impose a strong practical constraint on our plans for improving systems and business practices.

Consensus and Collaboration

Lasting reform demands consensus and collaboration. Few solutions rest exclusively within the jurisdiction of the financial management community. It is estimated that most of the information needed for financial management reports and statements originates in systems that are not under the control of the Department's financial community. Rather, such information comes from feeder systems--most notably from acquisition, logistics, medical, and personnel systems. It is an enormous challenge to upgrade these feeder systems to produce the needed information and to improve their interfaces with the Department's financial systems--especially since the primary purpose of those feeder systems is to support the U.S. military forces defending our nation, not to produce financial data.

The development of an infrastructure capable of providing more accurate and reliable financial management information and achieving auditable financial statements is a high priority of the Department. An infrastructure built around the integration and transfer of financial information between feeder systems and accounting systems is a Departmental goal and is necessary to enhance the sharing of information and to avoid redundant and sometimes conflicting data. The achievement of this objective is a Department-wide management challenge that requires a close cooperative working relationship among the Department's various functional communities. Therefore, much of our effort must, and does, involve working with other functional communities to upgrade their systems and to improve their interfaces with the Department's financial management systems. While this cooperative endeavor is well underway, much additional effort will be required to successfully complete the undertaking.

Changing Financial Management Environment

Legislation in the 1990s has changed the Federal Government's accounting requirements. More recent legislation requires audited financial statements from federal agencies. The Department's financial information must be collected and reported in accordance with new applicable Statements of Federal Financial Accounting Standards. These standards require more comprehensive accounting and reporting than the existing financial management systems were designed to accommodate. For the Department of Defense, this requires the Department to track financial data on items from their purchase to disposal in a more integrated process. No longer can we solely rely on separate systems monitoring separate categories. For example, if the Department purchased a patrol boat in 1975, we now must be able to identify when the boat was purchased; determine how much the Department paid for it and produce the original receipt; track where it is being used; or if it no longer is being used, determine if it has been offered for resale through the surplus property program, and, if so, when it was sold and for how much. And, we must have supporting paperwork for all these transactions, sometimes up to 18 months after the disposal or sale of the item. Obtaining a clean financial opinion requires an integrated and complete audit trail for millions of the Department's items, many purchased decades ago.

Accommodating these three constraints--continuing operations, building consensus and collaboration, and implementing process and system enhancements in the face of ever changing financial management requirements--imposes an enormous challenge. But the challenge is not just a financial management challenge; it is a Department-wide challenge that requires the involvement of all communities within the Department. The Department has accepted this challenge and each of the Department's functional communities actively are engaged in implementing various aspects of the Department's financial management reform initiatives.

CLOSING

In closing, Mister Chairman, I would like to thank you and the Subcommittee Members for providing me this opportunity to address financial management reform within the Department of Defense, and for your diligent oversight of financial management reform actions necessary to help improve the economy, efficiency, and effectiveness of government. The Department's financial management reforms are continuing to cut costs and improve effectiveness by exploiting the best of private and government practices. Especially productive are the extensive uses of consolidation, standardization, simplification, and advanced technology. During my tenure as the Department's Chief Financial Officer, I have witnessed substantial progress and an extraordinary transformation of the Department's financial activities, as well as other functional areas with which those activities must interact. Collectively, the initiatives addressed in this statement, as well as other initiatives underway within the Department, have built a strong financial management reform foundation upon which the Department can continue to build.

Mr. HORN. Thank you very much, Mr. Secretary. I'd like to know how you're proceeding to make sure that next year this situation will not occur. Are you working with the services and your people working with the services? Who are we pulling together to get the seriousness of this situation, and how are you going about it just as an open-ended question?

Mr. LYNN. Mr. Chairman, we have two approaches. We have a short-term and a long-term approach as I alluded to in my statement. Over the long term, as I think the other witnesses indicated, the only solution is systemic improvement. We need to get the finance and accounting systems compliant with the CFO Act and the other legislative requirements and we need—we're well within range on that.

Bob Lieberman may be right. 2003 is aggressive and optimistic but we're not going to be far off of that and I think he would probably agree with that, that we're going to be very close to achieving that date or something close to it for the finance and accounting systems. But for the other systems which comprise 80 percent of the data, the challenge is even stronger because those systems were never designed to provide this kind of data and it requires a complete overhaul of at least 70 critical systems.

To undertake that, our long-term approach is to set up exactly as has been recommended, a Y2K-like process that will take as we did with Y2K, take those 70 systems, go through the 5 phases starting with awareness through renovation to compliance and testing. As we move each of those systems into a compliant phase, we'll improve the financial management data of the Department.

That's a multi-year process. In order not to be waiting in line for that development, we've also developed a short-term process, short-term meaning less than multiple years but probably will take us at least 2, maybe 3 more years at least which is to develop, try to get a clean opinion by tackling deficiency, by deficiency, the problems that we have, working with the audit community, trying to develop—work around trying to develop auditable estimates. Where we can't produce the data through the systems, we work through the general property area relatively well on that area.

We're working now on the personal property area. We started to discuss some of the areas that were mentioned at the other end of the table in terms of environmental liabilities and health care liabilities. We're trying to take each of the major show stoppers that the auditors have identified and develop a short-term process that will give us more reliable data such that we hope we can get a clean opinion.

Mr. HORN. In testimony that will come after you leave, General Coburn will have spoken of several significant initiatives under way in terms of the Army and particularly the materiel command of which he's commanding general. I'm curious and also General Lyles for the Air Force materiel, he will have stated that the imperfect data is inevitable due to the 161 feeder systems that use thousands of interfaces to pass critical information. Now, Mr. Steinhoff noted in his testimony that the logistics systems and the general ledger systems are not integrated. Is that true?

Mr. LYNN. Yes, it is.

Mr. HORN. And what are we doing to try to get those? You know, about 4 or 5 years ago when Mr. Hamre came up here, my hearing was titled “what did you do with the $25 billion we can't find.” So I asked John how many years is it going to take to untangle that. He said, well, give me a couple of years. A couple of years went by and presumably you had it down to about $10 billion instead of the $25 billion and a lot of it was in the Columbus, OH, Army processing operation where checks were just spewed out to small business people, etc. And I wondered are we getting on top of acquisition and inventory so you can find some of these things and what's your feelings on this.

Mr. LYNN. I think what you're talking about in terms of the numbers with Dr. Hamre were problem disbursements. We brought problem disbursements down from a high of I think $31 billion half a dozen years ago to about $5 billion today.

We are gradually and steadily making progress on this. Progress, it involves going out to two causes. One of the causes was in fact the consolidation I described at the beginning of my testimony. When we pulled 330 finance and accounting stations into 26, there were inevitable difficulties in terms of recordkeeping and establishing proper internal controls.

We've had a number of issues. I think we have resolved most of those. We've now completed that consolidation as I said 2 years early, and I think we're working through now most of the organizational impediments to those problem disbursements. What remain are system impediments. In order to properly account for all of the disbursements and match them with the corresponding obligations, what we need are automated systems ultimately. That is, as I say by 2003 we think we will have those. We're about two-thirds of the way to that. It's that two-thirds of the way that has produced the progress that we've had to date and I think we will bring the number down very much further as we bring on the other third of new finance and accounting systems.

Mr. HORN. You obviously have jurisdiction over the three basic services; and when you look at some of that from how a financial statement is prepared, are the three services able to get commonality in terms of inventory categories? I realize they are very different between services, but that's something that the private sector certainly can solve. And when you've got different corporations under one large corporation in terms of a conglomerate, what's your feeling in terms of the services where the core of this whole operation starts with them and the only reason we have a Department of Defense is—that's to coordinate the efforts of the basic services. And of course, we've evolved in the last 20, 30 years with super agencies within Defense on accounting logistics and all that.

What's your feeling? Are you getting the basic raw material on the right steps that it aggregates to the financial statement or have we got weird things going on in the three services so they can never get in something that is inputted when it's aggregated step after step. So I'm just curious how difficult that is when you look at it from the top of the Pentagon to the people you're serving down at the bottom. How do you deal with that?

Mr. LYNN. There is certainly as you say, Mr. Chairman, inconsistencies between how the different military departments treat issues although I would not trace our challenges and problems to that primarily. We are generally able to overcome those inconsistencies and in particular with the establishment of the Defense Finance and Accounting Service, we're able to establish common policies and definitions and use those to build financial statements.

I don't think it's cross service inconsistencies that cause our problems at least primarily. The problems we have primarily and what I alluded to in our statement is the bulk of the systems and the systems for which the next panel is responsible for were never constructed to produce the kind of financial data that's necessary for financial statements. We're endeavoring to change those systems to put modules in those systems or to upgrade those systems to provide that data, but that's a massive task. That's the challenge. It's that challenge in changing the systems to establish a seamless Web from the logistics systems, from the personnel systems, from the medical systems into the finance and accounting systems. We need to be able to transfer that data in a seamless automated way. We're not now able to do that, and that's our main challenge.

Mr. HORN. So you're optimistic. Is that what that boils down to?

Mr. LYNN. Yes.

Mr. HORN. The basic number of accounting systems I assume was merged a little bit during the Y2K exercise. What number of accounting systems do you have within the Department of Defense at this point?

Mr. LYNN. We have 98 finance and accounting systems. We can provide that for the record.

Mr. HORN. Please provide it for the record.

I think there's been a figure when General Page was testifying here, and there was more than that 10 years ago.

Mr. LYNN. 10 years ago there were 330.

Mr. HORN. Was that it; 330?

Mr. LYNN. Approximately, yes.

Mr. HORN. Well, do you think—how much further do you think we can go with some basic accounting systems?

Mr. LYNN. We think we can get the finance and accounting systems down to about 30.

Mr. HORN. Have you ever examined some large corporations in this country and looked at how they do this? And have we learned anything from it, or is it something that just isn't relevant?

Mr. LYNN. It's relevant although not completely. The purposes for which commercial entities use financial statements are quite different. They use them in terms of bond ratings, in terms of loans. Frankly, we're not interested in valuing the Department so we can sell it. It's the—the differences are substantial; but where we have a common ground with commercial entities is, and I think it's what Jeff Steinhoff talked about, it's not the financial statement itself. It's the underlying systems that produce the data in the financial statement. And their corporate leaders need reliable and accurate financial data and so too does the Department. So to the extent that a financial statement is just a measure of your systems' ability to produce reliable and accurate data, then it's an important measure for the Department although the use in and of itself of that statement is quite different than in the corporate world.

Mr. HORN. I'm curious. Mr. Steinhoff, you've heard the testimony of Mr. Lynn. Where are the weaknesses?

Mr. STEINHOFF. Basically the weaknesses are in the systems. They've got disparate systems that were developed in a stove pipe environment, each service developing its own systems over the years. The systems don't work as intended. They don't tie together. They are not integrated. As all the panelists have said today, the systems can't readily exchange information. It has to be drawn out from the systems and even then you don't know if it is, in fact, reliable.

There's a big problem in processing transactions. It's an incredibly complex environment. One study done by the Air Force a few years ago found that if they changed the way they accounted for reparable items, in accord with private sector accounting, they wouldn't care if an item went from one status to another for purposes of accounting. But in DOD the way the system was designed, they accounted for every separate event. The study that was done for the Air Force found that they could have eliminated 155 million transactions or 78 percent of the transactions being processed. So they've got just a huge volume of transactions from systems that were developed many years ago and were not developed under a systems architecture for the Department.

You asked a little bit about best practices or what's done in the private sector. What we found in our study is that the finance and accounting doesn't sit separately in the private sector. It's integrated into the business processes. It's part of the business processes, and whatever comes out of the business process is adequate for financial reporting. The key being real time information of value to the business managers, which is the endgame the Comptroller General talks about.

What we're really looking for is for the financial information to come from the business systems as a by-product and for financial reporting to be something that just routinely occurs. Social Security is preparing their financial report within a matter of weeks after the close of the fiscal year whereas many departments struggle and take months and months because the systems, in fact, are not tied together.

Mr. HORN. Well, we thank you. I now yield 15 minutes to my colleague, the ranking member, Mr. Turner, the gentleman from Texas.

Mr. TURNER. Mr. Steinhoff, I want you to try to illustrate the importance of the issue we're discussing today by maybe giving us a few examples of what this failure to have these systems in place and to have the seamless transition data from the logistics personnel, medical, other systems and the financial management systems, what's this costing us? What's the cost to the taxpayers for the failure to come to grips with this issue that we come and talk about year after year which we still are talking about dates in the future when we hope maybe the financial and accounting systems will be in place in 2003 and then we haven't even talked about dates to get systems in place beyond that. Give us some sense of—if this is just a matter that accountants would like to talk about, then we can keep talking about this year after year; but somewhere in here I suspect there's a significant cost to the taxpayers for our failure to come to grips with this.

Mr. STEINHOFF. This has adverse impacts on the ability to control costs in the Department. For example, Defense has recognized the lack of cost-accounting systems to be one of its major impediments to controlling the cost of weapons systems.

Also, for the past several years, has had large losses in its working capital funds, in part because it's very difficult to set prices without good cost information. In addition, because of weaknesses in the systems, visibility over billions of dollars of assets have, in fact, been lost which puts these items at risk and also is one factor in purchasing items that are not needed. At the end of fiscal year 1999, I believe about 58 percent of Defense's secondary inventory, about $37 billion, is in long supply or unneeded. In part, visibility and good accounting information is one reason for that, not the sole reason but one reason.

We have found many times because of breakdowns in controls, things have occurred that shouldn't occur, and things haven't happened that should have. For example, we found that foreign countries have not always been billed under the foreign sales program because there wasn't good visibility over the deliveries that had been made so therefore the billings reports were not made. This past year we identified, for example, $330 million of R&D costs, non-recurring costs that had not been billed to foreign countries. In addition, some of these problems have been reported for decades, I want to put in perspective that the challenges Mr. Lynn and his top team are trying to tackle are decades old. GAO has been reporting on these types of problems since I've been at GAO, and that's over 25 years. Most of these areas are on our high risk list; so this is a very difficult issue.

I think there are also lost opportunity costs. Instead of managing by cost oftentimes people manage by budget. They get the budget dollars and obligate and spend the budget dollars without data on what was achieved in terms of cost, what was the cost of this depot as compared to that depot, or could this have been done this more efficiently and effectively. That's really one of the key components of the CFO Act. It calls for the systematic measurement of performance, it calls for the development of cost information, and it calls for the integration of systems. That's the key, that's the endgame. There is a great loss when you don't have that kind of data day to day.

Mr. TURNER. Secretary Lynn, can you add to that list? It's a fairly exhaustive list I know, but do you have anything to add to the areas that are apparent to you where we are actually costing taxpayers dollars because we have failed to get these systems in place?

Mr. LYNN. From my perspective, Mr. Turner, the biggest issue is to get at the infrastructure costs of the Department to try and reduce overhead. In order to be able to reduce overhead, we have to have a very precise understanding of what activities cost what amounts because we're going to have to try and streamline those activities. In that area, our data is limited and it limits our ability to reduce overhead. I think that's the biggest challenge that goes unanswered as a result of inadequate cost accounting systems.

Mr. TURNER. You mentioned this 2003 date you thought was a reasonable date. I think it's September 30, 2003 for getting the financial and accounting systems in order and in place. What's the estimate of what it's going to take to get the rest of the systems where they ought to be?

Mr. LYNN. That's the first job of this new panel that we have set up to review the systems first. As I say that number, we think, is about 70 but it may be—there's quite a few more systems in this area. We think there are 70 critical ones, but the first job is to review first what are the critical systems and what's a reasonable schedule to set up milestones for bringing these systems into compliance. So we'll have to provide that as soon as we've developed it in that panel.

Mr. TURNER. It seems like in order to carry out our oversight role, it would be helpful if we had that group establish those benchmarks, those deadlines and we could be aware of them and hold the Department to those dates. Otherwise, we're going to continue, down the path of talking about this and these dates continue to slip; and I think it would be very helpful to us if we could know about what date will we be able to see the entire schedule to accomplish this monumental task that we're talking about here today.

Mr. LYNN. I think that's a fair request, Mr. Turner. As I say, we can provide that for the finance and accounting systems. We've already provided it for the consolidation. As I said, we gave you a schedule for the consolidation; and we beat it by 2 years. The next stage which is making the finance and accounting systems compliant will be more difficult still, but we think we are on track for 2003. And we're developing the schedule for the third most important phase which is the compliance of the feeder systems and, we'll provide that schedule to the committee as soon as we have it.

Mr. TURNER. How long are we talking until that schedule will actually be developed?

Mr. LYNN. We're working on it this summer. Before the end of the year.

Mr. TURNER. When we talk about a schedule to accomplish these tasks, what are the elements necessary to shorten that timetable? We've heard references to perhaps the most important and that is leadership from the top, emphasis on this problem. What are the other elements? Are we talking about additional staff, additional dollars? What does it take to bring these systems to a point where we find them acceptable other than just sheer leadership and emphasis on the issue?

Mr. LYNN. It is going to take both additional staff and additional dollars. We have put additional funding into the 2001 budget request to accomplish exactly that. We'll be reviewing this budget. I think we'll build on that. It also will take additional staff. We're working with the IG and the GAO to go outside the Department's own capabilities in this area and to hire outside CPA firms to help us with the remedial efforts that we clearly need in developing these systems. We're hiring agency by agency individual audit firms to go through what the steps are in terms of system improvement in order to be able to clean up our financial data.

Mr. TURNER. Thank you, Mr. Secretary. I yield back, Mr. Chairman.

Mr. HORN. Well, I thank the gentleman. Those are excellent questions. Mr. Steinhoff, as a premise to the rest of the panel, in your testimony you stated that the General Accounting Office, the Army depot personnel identified 835 quantity and location discrepancies associated with 3,272 ready-to-fire hand-held rocket and launcher units. Now, could you describe how this happened and what it all means?

Mr. STEINHOFF. We visited the Army depot to really gain an understanding of its control system. We went to the first storage location and looked at one of the first items there. It was this hand-held rocket which is a sensitive item. Because of its classification as a sensitive item, it must be controlled by serial number and it must have a continual audit trail.

Those are the requirements from DOD, and we found items that were being stored that weren't on the accounting records, weren't on the property records. What we found working with the depot folks and they were very responsive and got right on top of this, what we found was that several shipments of rockets had been received but there was a glitch in entering it to the system. It rejected. It went into a suspense account. Automatically after 10 days anything that hadn't been cleared from suspense was just dropped. Therefore it wasn't flagged. The items were on the floor. They weren't on the records. At the same time, at the first location we went to, we found things on the floor that were on the records but they were on the records for a non-location. So in all we found 414 for which there was no property record that it was there, and we found another 421 that there was a property record but it was in the wrong place. So visibility is lost over this item.

Mr. HORN. Mr. Lieberman, I noted when Mr. Steinhoff was responding to my questions about what did you disagree with the Under Secretary and you were nodding your head so you seem to agree with Mr. Steinhoff and let me ask you about inventory. You continue to report on inventory controls and it's a major problem for the Department. In February, you reported the inventory problems related to chemical protective suits which have been identified more than 2 years ago and were still not corrected. Could you tell us what you found out?

Mr. LIEBERMAN. Yes. In 1997, we had reported that, at the defense depot in Columbus, there was very poor inventory control, drastic discrepancies in numbers of suits that were shown on the inventory records as opposed to suits that were actually counted when we observed physical counts. We recommended that wall-to-wall inventories be done.

There are 20 different types of suits. They are not all the same so it's important to keep them separate and keep good inventory control because these have to be issued to operating forces that are being deployed. DLA agreed to work on the problem in general, and fix the suit problem specifically. Part of their answer was to move responsibility for the suits and the suits themselves to the defense depot in Albany, GA. So we did a followup audit this year down there. We found the situation actually was worse. We observed a count of the inventory of 1 of the 20 types of suits, the most commonly used kind. The inventory records said there should have been 225,000 of them there and actually there were 194,000. No one could tell us what happened to the remaining 31,000 suits.

This is typical, I'm afraid, of the kind of inventory accuracy problems that we have been running across; and I think one of the advantages of the CFO Act which is commonly ignored is that it levies more stringent audit requirements on numbers that the Department of Defense in the past has just sort of accepted as being right without a whole lot of audit validation.

Inventory accuracy numbers are typical. Recently GAO reported that for the fourth quarter last year, DLA's inventory accuracy rate was only 83 percent, which is very poor for logistics inventory standards, and all three military departments have reported the same kinds of problems.

Mr. HORN. Now, in the potentially defective chemical protective suits, when you went back you found out they were not separated from the usable suits. I'm just curious what do these suits cost? What's the worth on them?

Mr. LIEBERMAN. The 31,000 missing suits were worth about $1.4 million.

Mr. HORN. $1.4 billion.

Mr. LIEBERMAN. Million.

Mr. HORN. Oh, I thought the Pentagon only had billions. OK. Sorry about that slip.

Mr. LIEBERMAN. They are not terribly expensive on a per unit basis. They are just glorified rubber basically.

Mr. HORN. What about the separation? Why are they saving potentially defective chemical protective suits? Is there some rigmarole they have to go through to get them off the inventory or what?

Mr. LIEBERMAN. I have to be very careful talking about this particular case because sentencing proceedings are still in process for some contractor personnel involved in selling defective suits to the government and some of the questions pertaining to what was wrong with the suits are involved in the sentencing procedures. But in general, again I'm afraid this was not as much of an anomaly as we might think. There are a lot of products in the inventory system where the lots are merged together, where we don't have particularly good visibility over exactly what we have where. And when an issue does come up concerning the quality of something, whether it's a chemical suit or fasteners or something like that, sometimes it's difficult for the supply people to isolate that particular batch because everything has been merged into a warehouse or into a bin in a warehouse or on to shelves.

And the typical warehouseman can't distinguish them. They all look the same to them. So if there's not serial item control like there is with a piece of equipment, it gets very difficult sometimes. There were several reasons involved why DLA was slow in getting these particular suits out of the inventory. Some of them had to do with communications both within the depot and between DLA and the users of the suits around the world.

Mr. HORN. I'd be curious how that's used. I mean, are these used by soldiers on the line, by fire departments on various bases or what? If somebody says we need 20 of these at Leavenworth or Camp Stewart or Fort Stewart and they go grabbing 20 and they don't know whether they are defective or not defective makes no sense to me.

Mr. LIEBERMAN. Absolutely. There's no rule any place that says it's OK to keep known defective products in the inventory. The problem here was that after questions were raised about the quality of the suits, DLA did not react fast enough to find them and pull them back. These suits are used by combat units. They are issued to people who would face possible exposure to nerve gas agents and things like that.

Mr. HORN. So if in our various pursuits around the world now, if someone says in Kosovo, a major country, says wait a minute, we'll slow them down and they don't have the protective suits because they are defective.

Mr. LIEBERMAN. Fortunately the inventory of chemical suits was very large so I haven't heard that pulling the defective ones out has really had a readiness impact. But I would have to get back to you on whether there's any perceived shortage.

Mr. HORN. I just wondered. It seemed to me a good master sergeant would straighten that inventory out with the services. Maybe the Defense Logistics Agency, maybe they don't have a good master sergeant. That might be part of the problem. But it seems to me when you find there is something wrong, you get rid of it and granted if the contractor's playing games, then the need is to deal with that contractor. Apparently they are from what you tell me.

Mr. LIEBERMAN. Yes.

Mr. HORN. Let me just cover a few more things because I know Mr. Lynn has other commitments also. Let me ask about Mr. Steinhoff as a predicate to this with Mr. Lynn on the antideficiency act. Do you find in the GAO where anybody in any cabinet department and particularly Defense ever even talks about the antideficiency act.

Mr. STEINHOFF. I can't say for that meeting per se but that is an area that people in the financial community do talk about. It's a law on the books and, the issue of fund control is an important issue to the accountant. With respect to any penalties that might be accrued from having an Antideficiency Act violation, if that's what you're getting at, no, I know of no cases where there has been a criminal penalty from the violation.

Mr. HORN. In your testimony, you noted the Department was unable to support $378 billion in net costs, and that the Department typically uses unreliable obligation data as a substitute for cost data. Could you elaborate on that and tell us about the effects on budget data used by managers?

Mr. STEINHOFF. The CFO Act calls for the development of cost information. Across government, not just in DOD, across government, this represents a major challenge because government is typically managed based on budget numbers or inputs versus outputs and cost.

As I mentioned before, DOD cited the lack of cost accounting systems as the single largest impediment to its ability to oversee its weapons systems cost and development. And lack of good cost data affects the ability to make economic choices, such as A–76 studies, and investments in IT, to evaluate programs, such as health care which is a big cost in Defense, and to control costs such as working capital fund pricing that I mentioned before. Because of a lack of cost accounting systems, they've used budget data as a proxy forecast, and this budget data wasn't developed for that purpose. Also, it's basically not totally reliable itself, and therefore, the IG was unable to audit the Statement of Budgetary Resources. The Statement of Net Cost also could not be audited.

We find in our work that the obligated balances aren't always reliable. The unmatched disbursement issue impacts on this. The fund balance with Treasury or the cash account doesn't balance. So what you have basically is the need to develop accounting systems to provide this basic data.

Mr. HORN. Mr. Lieberman, what do you think about Mr. Steinhoff's comments on that $378 billion in net costs and the Department typically using unreliable obligation data as a substitute for cost data in, has that been your finding basically?

Mr. LIEBERMAN. Yes, it has. I certainly agree with that, and it's really important to have accurate obligation data because if you have invalid obligations on the books, you're tying up money that will not be used for anything else. And if you don't identify those obligations as being invalid by the time the obligation availability of the appropriation expires, you're never going to be using that money for the purpose for which it was appropriated.

Mr. HORN. Mr. Lynn, the ball is now in your court. What's being done to address this situation.

Mr. LYNN. I think it's what we've talked about, Mr. Chairman. What we're trying to do is shift a system that frankly for 200 years was designed around the presentation of the budget to Congress. That focuses on obligations and disbursements. For those purposes, the system works reasonably well. We're able to track those and report to our oversight committees on what—how we've spent the money and how it has been done in accordance with congressional direction. What we've only recently in the last decade or so tried to do is a business style accrual base system which is used for a different purpose, not so much for reporting to our oversight committees on how the budget has been spent but for the kinds of things that Mr. Steinhoff and Mr. Lieberman are talking about, evaluating costs in the working capital fund, trying to eliminate overhead by identifying activities that are low payoff and high cost, trying to understand the various liabilities over the long term the Department faces and to accord for those in the normal process. We're trying to shift that system. It is a substantial overhaul, and we're only partway there.

Mr. HORN. You noted that you're developing a comprehensive financial management improvement plan and have you had a chance to review that one yet? Where is that within the bowels of the Pentagon?

Mr. LYNN. We are producing our second one—excuse me. We've produced our second. We're in the process of producing a third. The difference, in the first one we largely focused on the financial and accounting world itself. In the second one we've moved out, tried to identify the feeder systems and the core of the third one will be to try and implement this Y2K process that we've talked about which will do the overhaul of those feeder systems and bring them into compliance with the various statutes.

Mr. HORN. Mr. Steinhoff, do you have any comments on the Department's financial management improvement plan or its implementation?

Mr. STEINHOFF. Yes. First, this is an important milestone, a step forward for the Department. I applaud those efforts. We did review the first plan. We've made a number of recommendations to the comptroller. They really get to some of the issues I mentioned before, the need to really describe this plan and maybe this is the third plan Mr. Lynn is speaking about, but how financial management will support the other functional areas. It will be very important that the plan go beyond financial reporting to the overall management processes of DOD. Also how the plan ties to budget formulation, how the several hundred projects in the plan actually tie together toward DOD's vision and how the quality of the feeder systems, that data will be improved because those systems need quite a bit of improvement.

The final comment I'll make about the plan, I said it before, it will be imperative, I can't say this strongly enough, that the concepts of Clinger-Cohen be followed. Clinger-Cohen has got rigor to it. It requires some heavy lifting. It requires some times for you to step back and not move forward until you've gone through certain milestones and certain steps but it is essential. At the IRS which also has serious systems problems, they have been put on a very strong Clinger-Cohen by the Congress where their funds are rolled out to them for modernization one bit at a time and they go through certain milestones and they've done certain things like having established systems architecture in place. And it will be very important that systems efforts—and this is, as I said before, a world class systems challenge, they are trying to deal with decades of problems here, that that be very strictly enforced and that those concepts be followed, no shortcuts be taken, and that the money be very well spent.

Also, I wanted to clarify a previous statement I had. I have an attorney here with me today. He commented I was wrong when I said that no one has been punished for antideficiency. There have been no criminal prosecutions is what I meant to say. There have been administrative admonishments to some employees.

Mr. HORN. Is it admonishments, or is it not trusting that particular contractor in the future? Clinger-Cohen ought to give them enough flexibility to say no; is that correct?

Mr. STEINHOFF. Yes, yes.

Mr. HORN. Mr. Lieberman, how does the Inspector General feel about the financial management improvement plan?

Mr. LIEBERMAN. I thought it was long overdue, and I think in fairness we ought to recognize that the idea was born in the Senate. There was a 5-year plan that OMB compiles, but the Defense authorization act from 3 years ago was now—created a new requirement for this plan and with a heavy focus on systems, which was absolutely appropriate. It is an evolving type thing, and, as

Mr. Lynn said, each year DOD has improved it and added things to it, which certainly needs to continue in the future.

There are still a few concerns I would have about it. I still think it's too much of a comptroller community document, not well known outside the comptroller community. I think it's still too much of a one-time annual snapshot as opposed to a living document that's used by management during the year to actually control this whole effort as a program. And it still doesn't have enough information in it on what is this is costing. There's beginning to be specific information on some of the systems, but everybody has wondered for 10 years what this whole effort is costing and even more, how much more do we have to spend to get from here to there. So with the proviso that there is going to be continued effort to refine the plan, I think it's excellent.

Mr. HORN. Would anybody like to comment? And feel I haven't asked them the right question. You can have the last word on this.

Mr. LYNN. Let me take the opportunity, Mr. Chairman. You asked for the precise data on the number of accounting and finance systems. You'll find that on page 3 of my written statement, provide you the numbers starting in 1991 and going through the plan in 2003. In terms of a wrap-up, Mr. Chairman, I want to thank again the committee for holding the hearing and frankly keeping our feet to the fire. This is an important area. I think we have been treating it as such. As Mr. Steinhoff has indicated, this is a decade, and I would actually say centuries. We went centuries without trying to do this.

It is going to take us at least decades to establish the kind of controls and systems that we think we need to provide the data, but I think we have made two important steps forward in terms of the consolidation of the financial operations of the Department. We're nearly there in terms of the upgrade of the finance and accounting systems, both Mr. Lieberman and Mr. Steinhoff have appropriately pointed out that we need to broaden this beyond the comptroller community, beyond the finance community and get at the logistics, the acquisition and the personnel and the other communities to make sure that the data that comes into the financial system from those areas is audible and reliable and accurate. We're working with those. I have worked closely in particular with Jack Gansler who is the Under Secretary who oversees most of those to try and make that happen. Thank you, Mr. Chairman.

Mr. HORN. We thank you. Can we get the IG and the GAO to stay with panel II? We'd appreciate it. We'll get some closure here. So you're certainly excused, Mr. Secretary, and thank you for coming. We wish you well.

Mr. LYNN. Thank you, Mr. Chairman.

Mr. HORN. We now go to panel II, General Coburn, General Lyles, and Vice Admiral Amerault. So if you'll please come forward. We'll swear you in.

[Witnesses sworn.]

Mr. HORN. The clerk will note that the three witnesses have affirmed the oath. And we will start with General Coburn. General, it's good to see you again.

STATEMENTS OF GENERAL JOHN G. COBURN, COMMANDING GENERAL, U.S. ARMY MATERIEL COMMAND; GENERAL LESTER L. LYLES, COMMANDER, AIR FORCE MATERIEL COMMAND; AND VICE ADMIRAL JAMES F. AMERAULT, DEPUTY CHIEF OF NAVAL OPERATIONS

General COBURN. Good to see you, sir. Mr. Chairman, members of the subcommittee, I thank you for the invitation to appear here today. I express my appreciation to all the members of the committee for your efforts to improve our business processes.

Let me start by saying that we know we have an obligation to be good stewards of every dollar that is given to us and to be good stewards of Army assets. Put another way, we recognize that stewardship of Army assets is every leader's business, and we know that without effective asset accountability and control, that we cannot effectively measure performance, reduce costs, and maintain adequate funds control. In that regard, I can tell you that the Army leadership in consonance with DOD is committed to the Department's financial management improvement plan and that much progress has been made in the last few years. We recognize however that we still have a ways to go and significant initiatives both short term and long term are under way as we move toward the goal of a single integrated financial system.

Let me just highlight a couple, and I'll try to do that very quickly. One of the most important initiatives that the Army has under way is a program called the single stock fund. I'll just make a few comments about that, and will not be in consonance with the oral statement I think you have. Currently the Army has two stock funds, a retail fund and a wholesale fund. This means that we have layering and duplication of both financial and logistics processes. Thus we're consolidating these two funds. This consolidation will result in the elimination of multiple ledgers, eliminate multiple billings, multiple points of sale and integrate all the automation systems. Overall, this is an Army-wide change in how we conduct logistics operations and associated financial processes which will allow us to capture costs with greater clarity. It is a fundamental change in the way we do business.

Another program that I'll highlight very briefly is the wholesale logistics modernization program, an initiative designed to modernize the army's two largest and most important wholesale logistics systems, we call the commodity commerce standard system and the standard depot system. And again, this is an extremely important initiative for Army. Those are but two. There are others that I won't highlight that are equally important.

I'm just going to go right to the summary with your permission and just say that although we have a ways to go, the Army is not just beginning to focus on accountability. We focus on accountability daily and consistently. But notwithstanding all these efforts, however, we acknowledge that we need a single integrated financial management system that will provide commanders and leaders with the financial information they need to most effectively use their resources. Mr. Chairman, that was brief. But I thank you and the committee for your continued support and look forward to your questions.

[The prepared statement of General Coburn follows:]

STATEMENT OF: GENERAL JOHN G. COBURN

COMMANDER, ARMY MATERIEL COMMAND

UNITED STATES ARMY

Mr. Chairman and members of the Subcommittee, I thank you for the invitation to appear here today; and I express my appreciation to the members of this committee for your efforts to improve our business processes.

INTRODUCTION

We know that we have an obligation to be good stewards of every dollar that is given to us and to be good stewards of Army assets. Put another way, we recognize that stewardship of Army assets is every leader's business. And, we know that without effective asset accountability and control that we cannot effectively measure performance, reduce costs, and maintain adequate funds control. In that regard, I can tell you that the Army leadership, in consonance with DOD, is committed to the Department's Financial Management Improvement Plan and that much progress has been

made in the last few years. We recognize, however, that we still have a ways to go. And, significant initiatives both short-term and long-term are underway as we move towards the goal of a single integrated financial system.

INITIATIVES

- Single Stock Fund

One of the most important initiatives that the Army has underway is a program called the Single Stock Fund. Currently, your Army has two stock funds -- a retail fund and a wholesale fund. This means that we have layering and duplication of both financial and logistics processes. Thus, we are consolidating these two funds. This consolidation will result in the elimination of multiple ledgers, eliminate multiple billings, eliminate multiple points of sale and integrate all the automation systems. This Single Stock Fund will streamline current operations that have caused numerous

inefficiencies and duplicative automated systems that are managing the same inventory. The Single Stock Fund is a major step in moving the Army towards improved fiscal accountability. It provides essential visibility over inventories across the Army -- and with that visibility will come the ability to make prudent procurement, stockage and repair decisions. Overall, this is an Army-wide change in how we conduct logistics operations and associated financial processes which will allow us to capture costs with greater clarity. It is a fundamental change in the way we do business.

WHOLESALE LOGISTICS MODERNIZATION PROGRAM (WLMP)

The Wholesale Logistics Modernization Program is an initiative which is designed to modernize our Army's two largest and most important wholesale logistics systems -- the Commodity Commerce Standard System (CCSS) and the Standard Depot System (SDS). These two systems support wholesale logistics at our integrated

materiel management centers, our depots, our arsenals, and Army Materiel Command installations. To make this modernization happen, we have let a 10-year contract to Computer Science Corporation (CSC) et al. CSC will both design and operate the system. This modernized system will give us the ability to provide total global asset management in real time. Senior planners will have access to up to the minute information on quantities, location, and total dollar value of Army logistics assets worldwide. This is an extremely important initiative for our Army.

OTHER INITIATIVES

- Logistics Integrated Data-Base (LIDB) which is designed to identify and consolidate equipment asset values for the Army. LIDB contains all standard cataloging information for all Army owned items to include the current and historical unit price for all classes of supply and in-transit visibility of assets.

- Army Total Asset Visibility Program -- integrates Army asset, item, in transit and weapons systems data providing an authoritative source of asset information in support of managers/decision makers at all echelons throughout the Army.

- Defense Property Accountability System (DPAS) - Ensures accuracy of accountability records for personal property valued at $2500 or more by linking acquisition and payment systems with property accountability systems. DPAS is currently deployed to 120 Army sites with 30 more scheduled for implementation. To ensure the effectiveness of implementation, the Army has contracted with Price Waterhouse Coopers to facilitate and oversee DPAS implementation.

SUMMARY

Although we still have a ways to go, the Army is not just beginning to focus on accountability. For example, company commanders

routinely conduct wall-to-wall inventories for general equipment whenever they change commands and Army regulations require that inventories be conducted for all Army equipment at least yearly. Further, audits at property book level consistently shows that inventories match property books. So, we believe that our physical accountability for property is good. Notwithstanding all these efforts, however, we acknowledge that we need a single integrated financial system that will provide commanders and leaders with the financial information they need to most effectively use their resources.

Mr. Chairman, I thank you for your continuing support and I look forward to your questions.

Mr. HORN. Thank you very much. Let us now turn to General Lyles. General Lester L. Lyles is the commander of the Air Force materiel command.

General LYLES. Mr. Chairman, I appreciate the opportunity to come before this committee today. On April 20th, Mr. Chairman, I assumed command at the Air Force Materiel Command in Dayton, Ohio Wright-Patterson Air Force base. Prior to that time, I served as vice chief of staff of the U.S. Air Force. And in that capacity, I had an opportunity to witness and watch, particularly for the last 2 years as my predecessor, as the commander of AFMC brought a business management perspective to Air Force Materiel Command.

He instituted a policy of cost accounting, cost control, and, more importantly, a cost culture to everything we do in Air Force Materiel Command, from research and development to acquisition to logistics to sustainment to actually taking things out of the inventory.

Mr. Chairman, I am a big supporter of what General Babbitt started, and my plans are to continue that posture for Air Force Materiel Command. And I've let the entire command know that in the 2 weeks since I've been in charge.

Air Force Materiel Command is very, very big business. Accurate and timely financial information is absolutely key to our management and stewardship of the $26.3 billion of appropriated budget and the $13.2 billion of annual working capital fund budget. It's a very complex business. And the complexity of that business makes financial information important, but as you know and as the panel members before me recently stated, it's very, very hard to obtain. Without timely and accurate information, programs like F–22 program and the program directors in charge of it will not have the opportunity to do solid costing and schedule information for managing that program. Our depot maintenance foreman cannot manage their costs. The supply chain manager has difficulty doing his day-to-day inventory management and doing his responsibilities and even things that are seemingly mundane to some people as the lodging manager, will not know whether or not he has met his cost in performance targets and is doing a good job of managing his programs.

Mr. Chairman, we know we have imperfect data. That's been stated by the panel before us. You are very well aware of that. That is inevitable as you quoted earlier with the 161 legacy feeder systems and the thousands of interfaces that have to pass critical information. And these interfaces require weeks to run. As a former manager and commander of one of our logistics systems, the logistic centers and depots, I can tell you I would have loved to have the opportunity to close our books in a matter of days as industry does. It takes weeks and sometimes a couple of months to actually do it with the systems we have today.

So we're trying to make strides to improve that. There are lots of deficiencies, and we are trying to make corrections of all those deficiencies. I will not go through all the details. You have my draft written report in front of you, the written report that has some descriptions of some of the systems.

I'd like to mention just a couple because I think there are major milestones toward trying to achieve the objectives that you, this committee, and others want us to achieve. In the depot maintenance area we're partnering with Defense, with the Air Force audit agency, and with the Navy to implement the depot maintenance, accounting, and production system. DMAPS is the acronym. And this suite of systems will give us the actual cost information and automated billings processes and strengthen the cost controls that we need in order to have CFO compliance.

For the supply chain manager, we're trying to mirror commercial practices and bring in commercial practices as much as we possibly can. General Babbitt, my predecessor, back in October when he testified before the Military Readiness Subcommittee talked about some of the things we're doing such as going to moving average costs for inventory accounting rather than the latest acquisition costs to value the inventory, the millions of inventory that we have in our system. You understand what that means. I won't go through a description of it. There is an example given in my written account.

We think this is very, very important to us to allow us to get our arms around this very critical function and again to get us to a point where we can be CFO compliant.

We've also gone to data warehousing to improve supply management costs visibility and oversight. One system that we call Keystone is helping us to sort of bridge, if you will, between the systems we have for financial accounting and the systems we have for just managing systems and keeping inventories. This is a link between the logistics systems as the previous panel discussed and the financial systems that are very, very important to managing our day-to-day business. We will continue toward making those kinds of strides and bringing on systems like that.

One last comment for addressing total ownership costs which is very, very important for the U.S. Air Force and particularly for our major weapons systems. We're using target costing for all of our installation and support activities. This activity base costing methodology is one that we're trying to implement throughout the entire Air Force but particularly in Air Force Materiel Command.

As the former vice chief of staff for the Air Force, I was responsible for trying to make activity-based costing a rubric—a mandate for everything we do in the U.S. Air Force whether it's flying airplanes, whether it's preparing systems for deployment, or whether it's developing the major systems we're trying to use to provide capability to our war fighter. This target system, activity-based accounting system is very, very important to us and we're going to continue strides to bring that into the entire Air Force, not just to the materiel function.

Mr. Chairman, we've mapped the road toward CFO compliance. We think it's the only thing that we have to do. We think it's extremely important in everything that we do. We've identified the audit findings and material weaknesses and we are trying to address each one of those. We've closed 103 of the 121 audit findings against the U.S. Air Force and all the materiel weaknesses, and we will continue strides to close all of them.

In summary, Mr. Chairman, we know we don't have a perfect system. We know we have untimely data. We know we have some systems that provide us occasionally dirty data, but we're making strides and we have the energy to improve that and to use a word that you used earlier, we are fully committed toward these endeavors. We think we're on the right road, and we're proceeding aggressively and we hope responsibly to make those improvements for the U.S. Air Force.

I look forward to your questions, Mr. Chairman. Thank you very, very much for inviting me.

[The prepared statement of General Lyles follows:]

OPENING STATEMENT – 9 MAY 00 General Lyles

- Recently assumed Command of AFMC
- Very supportive of the Business Area Management focus by my predecessor – Gen George Babbitt
- "Cost Accounting", "Cost Controls", "Cost Culture" is key to managing this complex business
- I will continue this very important emphasis

Air Force Materiel Command is big business. Accurate and timely financial information is absolutely key to our management and stewardship of a $26.3B appropriated budget and $13.2B working capital fund budget.

The complexity of our business makes financial information important, but hard to obtain. Without timely and accurate information, the F-22 Program Manager as an example does not have solid cost and schedule information; the depot maintenance foreman cannot manage his costs; the supply chain manager has difficulty with day-to-day inventory management; and the lodging manager does not know if he met his cost and performance targets. We know we have imperfect data which is inevitable because of the 161 legacy feeder systems which use thousands of interfaces to pass critical information. These interfaces require weeks to run. As a result, instead of closing our books in days as industry does, we close our books in terms of weeks.

To correct deficiencies in our accounting systems and improve timeliness, we are putting a lot of energy into improving the quality of our financial information. In Depot Maintenance, we are partnering with the Defense Finance and Accounting Service, the Air Force Audit Agency, and the Navy to implement the Depot Maintenance Accounting and Production System. This suite of systems will give us actual cost information, automate the billing process, and strengthen funds control. It is a giant step toward

Chief Financial Officer Act compliance and meeting Defense Contract Audit Agency Cost Accounting standards.

For the Supply Chain Manager, we are trying to mirror commercial practices. We have established a project management office to change the way we value inventory. As General Babbitt pointed out in his October 7, 1999 testimony before the Military Readiness Subcommittee, Committee on Armed Services, U.S. House of Representatives, we plan on using moving average cost instead of latest acquisition cost to value inventory. While latest acquisition cost may be useful for future cost estimates and budget projections, it does little to help the supply chain manager control today's costs. For example, if we purchased 10 items at $10 apiece, the inventory value would be $100. If we buy an eleventh item for $25, we would revalue all 11 items at $25 for a total of $275. This cost inflation makes it very difficult to hold a supply chain manager accountable. Revaluing our inventory will fix this, move us toward Chief

Financial Officer compliance, and greatly simplify supply accounting. We have also used data warehousing to improve supply management cost visibility and oversight. This effort, called Keystone, helps us transition from fiduciary information to managerial information. It closes the gap between our financial and logistics activities by pulling data from several legacy systems and providing us with worldwide sales data by source of supply. It allows a Supply Chain Manager to drill down to a specific national stock number and obtain cost and sales information.

To help us address total ownership costs, we are using target costing for our installation and support activities across the command. This will improve cost management of such diverse areas as Information Management activities, the base Civil Engineer, and the base lodging office. We have mapped our costs to specific outputs, set target costs, and instituted quarterly execution reviews. This type of target costing has helped us drive down costs and allows us to submit a balanced 5-year budget.

We have worked with HQ USAF to improve the auditability of our books. Three times a year, we verify the accuracy and validity of 90 percent of our open obligations. This allows us to better understand our true liabilities, cleans up our balance sheet, and reassures the public we are good stewards of their tax dollars. I am initiating a similar effort for our accounts receivable. Again this will clean up our balance sheet and improve our statement of budgetary resources. We have mapped a road to CFO compliance. We have identified those audit findings and material weaknesses that prevent us from being CFO compliant. We have closed 103 audit findings and material weaknesses. Major system initiatives such as DMAPS will allow us to close the remaining roadblocks

In summary, we do suffer from dirty and untimely data. We are putting a lot of energy into improving that data. This is not an easy task. There are many players and the processes are complicated and supported by old legacy systems. In some respects, it is like trying to change a flat tire on an airplane while it is flying.

Mr. HORN. Thank you, General. It's very well done. Our last presenter on panel II is Vice Admiral James F. Amerault, the Deputy Chief of Naval Operations for Logistics. Admiral, go ahead.

Admiral AMERAULT. Mr. Chairman, distinguished members of the panel, thank you for the opportunity to appear before you today. Although I don't believe that the bottom line of a balance sheet can tell us that we are ready for war or not, as Navy's Deputy Chief of Naval Operations for Logistics, I do understand completely that reliable and accurate financial information is extremely important in reaching that very readiness. My staff identifies requirements for materiel and services in support of logistics. And they program discrete levels of funding for them in the defense plan. The quality of the financial information on which these actions are based is critical to us getting it right.

As Navy's infrastructure manager, I've looked very hard at reducing infrastructure costs in order to modernize and sustain operational readiness. Again, the quality of financial information can be critical to Navy decisionmakers as they consider appropriate actions to reengineer processes to effect cost reductions. In some instances the lack of financial data could cause us to miss an opportunity as Mr. Lynn has said, an extremely large opportunity cost that we can't afford to take appropriate action all together and preclude us from identifying savings or diversion of funds to other war-fighting priorities.

It's impossible to determine how much is enough if you don't know how much you have. The idea that what things cost equals what was spent on them has persisted for a very long time. Today's declining budget top lines as well as our accountability to the taxpayers say that time has been too long. I'm ready for your questions, sir.

[The prepared statement of Vice Admiral Amerault follows:]

DRAFT VADM AMERAULT's ORAL Statement

Mr. Chairman and other distinguished members of the panel, thank you for the opportunity to appear before you. As Navy's Deputy Chief of Naval Operations (Logistics) financial information is very important to me. My staff identifies requirements for logistics programs and programs a discrete level of funding for them in the POM. The quality of the financial information on which these actions are based is critical to us getting it right. I'm also Navy's infrastructure manager. In this role I have looked very hard at reducing infrastructure costs in order to modernize and sustain operational readiness. Again, the quality of financial information is critical to Navy decision-makers as they consider appropriate actions to reengineer processes to effect cost reductions. In some instances the lack of financial data may have caused us to miss an opportunity for appropriate action altogether and preclude us from identifying savings and diversion of funds to other Navy priorities.

Financial information is so important to Navy Logistics in the 21st Century that I have included a Financial Goal as one of four strategic planning goals. The financial goal reads... Achieve optimum warfighter readiness at lowest cost. We cannot achieve this balance unless we first establish a link between cost and readiness, and second, have robust and actionable financial data available. It is one of my priorities to greatly improve the level of detail and accuracy of financial information to give decision-makers the tools needed for success.

We lack perfect financial information today. This hinders our efforts to some extent and as a consequence we are working hard to improve it. Activity Based Cost Management (ABCM) is a tool that will help, and I am the Navy lead for coordinating its implementation. ABCM is a tool that will allow decision-makers at each activity to manage costs associated with their specific products or services, rather than rely on the traditional categorization of costs by appropriation, organization, or weapon system. Better informed decisions, that is decision based on enhanced cost data, are expected to result in actions that reduce costs and increase value to our customer. application of standards to financial information will also allow for benchmarking which will drive process redesign and exportation of best practices Navy wide.

In support of the revolution in Business Affairs, DON is committed to reducing costs and improving performance of business processes throughout our enterprise. I, as DCNO (Logistics), am a primary stakeholder in Navy's business policies and processes and the associated business infrastructure. Top line fiscal constraints will continue to necessitate reduced costs in this area to allow funding for other priorities. I lack the financial information to enable what I consider sufficient analytical rigor to be brought to bear on the problem.

To improve financial information I am also investing in improving non financial "feeder" systems. For instance, accurate asset reporting, which is essentially a logistics issue is a "source" which drives financial information. One of my senior managers is engaged in the area of Personal Property management and financial reporting as the Navy CFO compliance Team Leader.

Improved integration of today's legacy information systems is absolutely necessary. I need enhanced logistics data as well as associated financial information to identify savings opportunities. Integrated information systems such as Enterprise Resource Planning is one initiative being pursued and I endorse it. Tools such as this would simultaneously and accurately update information in all applicable data bases, synchronizing information throughout the system. This enhanced information would enable best management decisions, drive efficient actions by all parties and enable increased controls over processes.

In summary, logistics programs would benefit from improved financial information. We simply could make better use of limited resources.

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Mr. HORN. Thank you very much. Let me ask our friends, the Inspector General and General Accounting Office, they've commented on both the inventory controls and we might as well start with that since we had a few examples. Inspector General and GAO and the audits generally have repeatedly reported on the military service's quote weak controls over inventory including weapons and ammunition. Mr. Steinhoff noted that weak inventory controls can lead to inaccurate records, and inaccurate records can effect supply responsiveness and purchase decisions. Do you agree with that or where are we from the three services? General Coburn, you want to start?

General COBURN. Mr. Chairman, I think that as has been stated we do have problems with inventory, but it's a consistent daily battle. We get very concerned whenever we have any shortages of any kind, particularly with weapons. I can tell you that when commanders, even at the company level, change command, they are required to do a total 100 percent inventory of weapons, ammunition, all equipment, and sign off on it as all being there, that they have physically counted and looked at it personally. Notwithstanding that, we continue to have problems with inventory.

When I get into it, when I invariably find that you haven't lost anything, it's simply that you have a record keeping—a paperwork problem. So that's what I find time after time. I can also tell you that we get so concerned about it that on occasion we have senior commanders verify the same kind of thing as we have our junior commanders do. So I think that there's lots of room for improvement in the system, but I think that by the same token that we basically know what we've got and that control is really pretty good because there's an awful lot of systems.

I can go on and tell you there are a lot of complementing systems as well. It's not just the inventory system. It's also the system where you have—you know, we have service inspections. Some equipment like ammunition, rockets, that kind of thing, you have to not only look at it to make sure it's there but make sure it works. So when you're looking at it to make sure it works, there's a cross-check to make sure the inventory is correct as well. So I guess that's kind of the way I see it. Again, problems but not a perfect system but a system that we continually work at.

Mr. HORN. General Lyles.

General LYLES. Mr. Chairman, I agree with the comment from General Coburn. It's a very insidious problem because it's one that ultimately affects a lot of different things. Invariably we find in looking at inventory and checking inventory that we haven't lost things but the paperwork is very, very complex and very, very tedious to try to locate exactly where they are or even what the status is of various inventory items.

We had examples of that during the air war with Serbia last year, the Kosovo activities. As we tried to track munitions and make sure we knew where they were, what the status of the various munitions, particularly some of our high-valued accurate munitions we needed to prosecute that particular war. The issue is the manpower intensive which is a major, major problem when you consider the downsizing that we're facing today, when you consider that we need to have our young men and women doing other things instead of just tracking paperwork, both at a junior level and a senior level. So the complexities of the systems have made it somewhat of a manpower drain to us.

We feel that we have a head on where things ultimately are, that is, we haven't lost things completely but it becomes very, very tedious to try to track them. We need automated systems where we can instantly understand and account for where systems might be. That same thing carries over when we're talking about developing new systems to contractors. The inventory, whether it's government-furnished property or equipment, that we provide to contractors has a similar sort of situation. We can track it but there are like three or four different systems we have to do—look at to do that. It becomes very tedious to us and the contractors. So it is a major problem.

Mr. HORN. Admiral Amerault, you want to add to that?

Admiral AMERAULT. Yes, sir. I believe we do a pretty good job of accounting for what we have in inventory, particularly in the field in ships and activity squadrons and detachments and so forth. There are places where this has been a problem. Receipts in some cases have not tracked in both the inventory records and the financial records causing us to not know on the financial side what we've got on the physical inventory side. This is important.

Control is a key, generally good but the detail to have the kind of accurate control that one might need on both sides of the ledger, cost dollars, people, and time. I think there's a lot of room for improvement. I think IT systems have come to the point where the investments that we're now making in those will help us close the gap.

We don't think this is unimportant. We think it's very important. As I said, it's really hard to tell how much is enough if you don't know how much you've got. We're dedicated to fixing this. I would say that support of our Navy-Marine Corps intranet that we are attempting to invest in and purvey throughout the Navy is an important step. I would urge the committee to support that effort on our behalf. Thanks.

Mr. HORN. Mr. Steinhoff, do you agree that progress is being made in the three services or do you see the same thing every year when you go back?

Mr. STEINHOFF. We continue to find a number of the same underlying problems with the systems. With respect to this area, there's a lot of attention being placed on it. We've seen commitment; but until the underlying systems are fixed, it's going to be very, very difficult.

The comment that General Lyles made about using the members of the military to track items and to try to find items, it's a real difficult issue. These are incredibly complicated systems and processes, so complicated it makes no sense. And you don't enter information one time and it goes from system to system. So not only are the logistics systems not integrated or compatible with the financial system, they may not be compatible with each other either.

So you've got a real disconnect here, and when something is shipped from point A to point B, it's in transit. You might lose visibility over that item. It's a very difficult issue. I would say there is certainly a commitment. We've seen all the services working toward making changes to reduce their business operations costs to be more efficient, effective; but they all face a major systems challenge which isn't easily overcome.

I know I've emphasized this a lot, but there hasn't been great success in government or great success in DOD in systems development, and you're going to have to have common systems in some cases, standard approaches for addressing it, and a lot of reengineering.

Mr. HORN. I would think that in an inventory, you've got a way to certainly have an electronic inventory and to what degree do you see that or are we still just putting checks on papers? When I got here, I couldn't believe it that the General Services Administration in its St. Louis operation to which all our district offices can ask for supplies and so forth would automatically send five invoices together. I said this is crazy. We only need one. We've got a Xerox machine. If we need two, and with getting reimbursements let's say in the Capitol's arcane reaches of trying to pay the bills around here, and it was just a waste of trees and papers. How often do you see that in the services or do they have it on electronic inventory? Mr. Lieberman.

Mr. LIEBERMAN. There's certainly been a concerted effort over the last few years to implement technology like bar coding. Clearly for many items the solution merely is to bar code them and then let the computer do your recordkeeping and calculations for you. This is a problem that has many different facets because when we talk about inventory, this is a hodgepodge accumulation of items. We're talking about everything from little consumables like screws to large equipment and subassemblies and things like that.

Some of it belongs to the services. Some of it belongs to the Defense Logistics Agency. Some is warehoused. Some is actually distributed to using units. Some is outsourced—we hire contractors nowadays often for supply support, and it's their responsibility to keep the inventory. In many cases DOD doesn't maintain anything in stock. We operate on a just-in-time delivery basis. There are, I believe, about 300 separate DOD logistics initiatives and a lot have to do with overcoming this asset visibility problem.

In most cases, the answer to whatever the problem is is application of a new technology. So a lot of effort is being put into it, but a lot more needs to be done and then we still have human problems. We still have the guy assigned to do the inventory who doesn't feel like doing it so he looks up the record to see what's supposed to be there and low and behold that's what he reports. Then someone else has to come along, and we've actually had cases like this during these audits this year, and redo the task. The auditors may do another count. The auditors say, hey, none of these quantities match.

So we're fighting human fate a little bit. To give on just very mundane example, at one of the defense depots, the people were supposed to wait for the auditors to arrive onsite to do the count because an accepted part of the methodology is the auditors observe part of the count. They thought they would speed things up by going ahead, then just hand the auditors the results when they got there. One of the first times we checked was a type of rubber seal that is inventoried by how many linear feet you have. The record said there should be 396 linear feet on the shelf. The count done previous day said there's 396 linear feet on the shelf. The auditors went and measured. This didn't take rocket science. There were only 200 linear feet on the shelf.

So that's the sort of thing that is never going to go away because we're talking about millions of items and thousands of people with varying degrees of responsibility over them, but ultimately the computer is the answer here. Fewer systems, and more diligence paid to the user friendliness of those systems so that we take administrative burden off the troops, are urgently needed.

Mr. HORN. Well, it would seem to me that with the services' chiefs telling all of us here we've got too much infrastructure, that what they ought to do is have a competition with various depots and the ones that aren't doing anything that make sense, get rid of those and keep the others.

But I think if we had a little competition in those depot things—now with the Naval shipyards I have a few very strong opinions. When you knock out the inefficient shipyards and—rather you save the inefficient shipyards, and you hurt the ones that threw the money back and never had to repair them a second time. And so that didn't give me much faith, I've got to tell you, in the Navy, in terms of how they make decisions. It seems to me let's get some competition in that.

If you've got all these things, you can get rid of those depots. Granted somebody will bark at you here, but I don't think we'll back them up. We also can't—it's a two-way screen. We also cannot—you can get the law through to have another base closure situation, but I just think you've got to let them expand. If they aren't doing anything let's do it another way. I don't know what your need in a geographic sense is needed. A lot of the services forward fund supplies as they should because there's no use going through some of the domestic problems when it ought to be closer to where you need it if you have troops sent there and this kind of thing. What else does the Inspector General and the GAO see they ought to be educated on if they aren't? I'm talking the services now, not you three gentlemen but if—are we missing something somewhere to get that moving so we don't go through this every year.

Mr. STEINHOFF. I think that the three gentlemen here today described very well the challenge very forthright. I agree with what they said about the challenge. I think that the one area of education, and I maybe beat it too much today, I apologize if I had, that there are no shortcuts in developing systems that must be done with a discipline process. And I feel very strongly that the Department has to look at the business processes and systems together and to put aside some of the stove pipes and barriers and view these as a corporate issue.

Our study of world-class finance organizations, the best practices in State governments as well as commercial enterprises, finds that when these types of issues are addressed at the CEO level, at the top level, that a lot of differences between units are put aside. Also it has to be viewed that financial management is providing something of value. I'm not sure across the Federal Government how many managers really understand what financial management can provide. So there's probably a broader educational process, not regarding these gentlemen, but perhaps across the organization.

Mr. LIEBERMAN. May I add one thing, Mr. Chairman. These gentlemen really are the business leaders of the Department. They are the closest thing in the Department to chief operating officers and heads of corporations. It's terribly important that they, the users of the financial information, tell the people that design these systems what it is that they need, because if you leave it to the accountants to decide what the managers need, you are going to get some bizarre answers. So we've got to just do everything we can to improve that user-systems designer interface.

Mr. HORN. Any other comments, Mr. Steinhoff?

Mr. STEINHOFF. No.

Mr. HORN. General, anything you'd like to get on the record?

General COBURN. No, I totally agree, Mr. Chairman, with what's been said. I would just say, though, that I'm heartened by what I see. We've never had visibility in Vietnam. We've been in a lot of excess. We never had it in the Gulf. We opened an awful lot of containers just to see what was inside. I think if you went to Bosnia and Kosovo you'd see it a whole lot better. The way that works the standard is a bar code, and then we put a little card inside the box. It's called an AMS card. It prints out everything that's in the box. The box goes in a container. An RF tag goes on the outside of the container and that goes through fixed level interrogators so we know what we've got along the way. I think that while much remains to be done, there's an awful lot of progress being made in a lot of areas. The key is pulling it all together it seems to me in the one system.

Mr. HORN. General Lyles.

General LYLES. Two comments, Mr. Chairman, that also give me confidence that we're certainly on the right road and we have the commitment. One is for us in the Air Force we closed two of our five depots. We're now down to three depots. We've aligned work and work packages and inventory from those two that were closed and to the three remaining depots, we have provided additional workloads so that we're almost worked in terms of manning levels at the three depots. This has put an even more of an imperative to make sure we have the right kind of financial accounting systems at those three depots. So for us, this becomes a mandate we have to stay on this course. We have to make sure we have the best, most efficient, most commercial-like systems and best practices that we possibly can and we'll continue that.

The second one is I think an even greater demonstration of leadership, support for this area. As I mentioned earlier, I was, prior to taking command of Air Force Materiel Command 3 weeks ago, I was a vice chief of staff of the Air Force, and in that capacity a member of the joint requirements oversight committee, the JROC, and the joint staff. And we within the joint staff, within the JROC over the last year, I dare say we reviewed business operating systems, asset visibility systems, the importance of those systems, the mandate from the chairman of the joint chief of staff, General Shelton, to put emphasis in that area just as much as we reviewed new weapons systems from F–22 to Comanches to what have you.

I think the commitment and recognition that this is a major problem goes to the very top of the Department, from the very top of the chairman and joint chief of staff to all the services; and I feel very positive that we have the right sort of focus to continue toward success.

Mr. HORN. That's very well said. Admiral.

Admiral AMERAULT. Yes, sir. Mr. Chairman, I think this is an area that we can't afford not to get it right. As I said, top lines are not going up for us. It's critical to us being able to do business and fund the readiness that we need that we get the financial data that helps us make accurate, timely, and good decisions as long, I hope, as we make military sense when we put those systems in place.

Obviously a ship full of weapons, operators, and people that make it move doesn't have a whole lot of room for stock clerks and pay clerks. So we need to take advantage of the key that IT gives us today to put in systems that are geared to do the job, do it right, and user friendly to us in a war-time environment. Thank you, sir.

Mr. HORN. Well, this has been very enlightening and you give me some optimism that things are going to change, and I'm glad to see that you're all working on that within your three services. It sounds like you've got the GAO and the Inspector General on your side so they are pretty good company to have. And I want to thank you all for coming and this is the staff. I want to thank——

Mr. Walden, we're going to adjourn so I want to introduce you to Mr. Coburn.

Mr. Walden is a valued member of this but he couldn't make it this afternoon.

So we thank J. Russel George, the staff director and chief counsel and Louise DiBenedetto, the professional staff to my left. Bonnie Heald, director of communications, Brian Sisk, clerk, and Elizabeth Seong and Michael Soon, interns; and on the minority side Trey Henderson is counsel, Jean Gosa, the minority clerk, and Laurie Harris has been our faithful reporter. Thank you and with that we are adjourned.

[Whereupon, at 3:50 p.m., the subcommittee was adjourned.]

[The prepared statement of Hon. Jim Turner follows:]

Opening Statement of The Honorable Jim Turner
GMIT: "Results of the Department of Defense's FY 1999 Financial Audit"
May 9, 2000

This is the sixth in a series of oversight hearings on federal financial management. To date, we have reviewed the financial management practices of the IRS, HCFA, HUD, USDA, as well as the annual governmentwide consolidated financial statement. Today we will turn our attention to the Department of Defense. Taxpayers deserve an accurate look at an agency's books and deserve to know how their tax dollars are being spent. Congress recognized, as early as 1990, with the passage of the Chief Financial Officers Act, that the federal government should maintain reliable financial information that can be audited. The Government Management Reform Act of 1994 required all 24 major agencies to conduct independent financial audits beginning in Fiscal Year 1996. Today, we have the opportunity to discuss some of the tangible results of this process with the audit of DOD's financial statements.

The DOD receives one-half of the annual discretionary federal funds. Despite the huge sums of money flowing through DOD, its financial management systems, practices, and procedures are hampered by critical weaknesses. Since 1995, the GAO has designated the financial management systems at the DOD as "high risk," because it is vulnerable to waste, fraud, and abuse.

I am disappointed to learn that because the financial information was not provided in a timely manner to allow the necessary audit work to be performed, the IG could not render an opinion on DOD's financial statements for fiscal year 1999. Additionally, the IG reported that internal control weakness, compilation problems, and financial management system deficiencies continued to exist. The IG noted that the internal controls did not ensure that accounting entries impacting financial data were fully supported or that assets, liabilities, costs, and budget resources were properly accounted for and reported.

It is important that we keep the public's trust in the ability of government to effectively manage the financial systems that fund the forces that protect our nation. I commend the Chairman for his focus on this issue and welcome the witnesses here this morning. I am hopeful that the results of this audit will further improve DOD's management and better protect the financial integrity of its programs.

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