

WASTE, FRAUD, ABUSE, AND MISMANAGEMENT

HEARINGS BEFORE THE TASK FORCE ON DEFENSE AND INTERNATIONAL RELATIONS OF THE COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES ONE HUNDRED SIXTH CONGRESS SECOND SESSION

HEARINGS HELD IN WASHINGTON, DC: JUNE 22 & JULY 20, 2000

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CONTENTS

	Page
Hearing held in Washington, DC, June 22, 2000—Inefficiencies in DOD's Health Care Claims Processing: The Need to Improve Performance	1
Statement of:	
H. James T. Sears, M.D., Executive Director, TRICARE Management Activity, U.S. Department of Defense	10
Stephen P. Backhus, Director, Veterans' Affairs and Military Health Care Issues, U.S. General Accounting Office	16
William J. Meyer, Senior Vice President of TRICARE, Blue Cross-Blue Shield of South Carolina	22
Prepared statement of:	
Hon. James P. Moran, a Representative in Congress from the State of Virginia	4
Hon. Paul Ryan, a Representative in Congress from the State of Wisconsin	5
Hon. John M. Spratt, Jr., a Representative in Congress from the State of South Carolina	5
Dr. Sears	13
Mr. Backhus	18
Mr. Meyer	25
<hr style="width: 10%; margin: auto;"/>	
Hearing held in Washington, DC, July 20, 2000—Pentagon Financial Management: What's Broken, How to Fix It	53
Statement of:	
Hon. William J. Lynn, Under Secretary of Defense (Defense) and Chief Financial Officer	56
Robert J. Lieberman, Assistant Inspector General for Auditing, U.S. Department of Defense	70
Jeffrey C. Steinhoff, Assistant Comptroller General, Accounting and Information Management Division, U.S. General Accounting Office	80
Prepared statement of:	
Mr. Lynn	59
Mr. Lieberman	73
Mr. Steinhoff	83

Inefficiencies in DOD's Health Care Claims Processing: The Need to Improve Performance

THURSDAY, JUNE 22, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON DEFENSE AND INTERNATIONAL RELATIONS,
Washington, DC.

The Task Force met, pursuant to call, at 10:05 a.m. in room 210, Cannon House Office Building, Hon. Mac Thornberry (vice chairman of the Task Force) presiding.

Members present: Representatives Thornberry, Shays, Buyer, Moran, Spratt, and McDermott.

Mr. THORNBERRY. We are going to go ahead and get started. Mr. Moran is on his way and will join us shortly.

Let me welcome our witnesses and guests. This is the eighth in a series of hearings held by the Budget Committee to identify management and financial improvements to make government agencies more efficient and effective. Of course, making the most out of each taxpayer dollar is important to all of us and I certainly appreciate Chairman Kasich's focus on those issues.

Today, we are going to concentrate on improvements to the military health care system as part of an overall effort to improve quality of life for our military. Senior leadership at the Department of Defense and especially Chairman Shelton have committed themselves to making significant improvements in the TRICARE program. Unfortunately, the President's budget proposal this year did little to meet the full range of expectations which were created by the Chief's support.

George Washington once said that the willingness with which our young people are likely to serve in any war, no matter how justified, shall be directly proportional as to how they perceive the veterans of earlier wars were treated and appreciated by their nation, and that, in sum, is the heart of the reason this issue concerns me, not just doing right by retirees but how we can get and keep top-quality people in the military.

In May, the House passed a series of improvements in the Floyd Spence Defense Authorization Act to try to deal with a number of quality of life issues. Included in that was a 3.7 percent pay raise, adding money for housing allowance, dealing with the food stamp issue, and a number of improvements dealing with health care. I am pleased today that on our panel the chairman of the Personnel Subcommittee of the Armed Services Committee, the gentleman from Indiana, Mr. Buyer, has joined us, because he is responsible

for those improvements, as well as others which Congress has made over the past few years.

Among other things, we learned during Chairman Buyer's hearings that inefficient claims processing and payment were among the most significant factors undermining the provider and beneficiary support of TRICARE. We also found that substantial savings could be gained by reducing the cost of processing military medical claims. It is a disturbing fact that the average cost to process a Medicare claim is \$1.78 while the average cost to process a TRICARE claim gets close to \$8. There are a variety of reasons for those differences we will be talking about today, but the bottom line is, we could save up to about \$500 million over the next 5 years if we can improve the paperwork and processing costs.

We are going to try to shed some light on the opportunities for those improvements and how managed care support contractors and DOD health officials can work together to reduce administrative requirements for TRICARE. I think the bottom line for all of us is that this money which is being used for administrative costs and paperwork could be used for health care, and that is certainly what we would prefer to have done.

At this time, I would yield to the chairman of this task force, the gentleman from Connecticut, for any statement he would like to make.

Mr. SHAYS. Thank you, Mr. Chairman. I also welcome our witnesses and guests.

Last year, I sat down with a squadron of F-15 pilots at Hurlbert Air Force Base in Florida and asked what was on their minds. I expected to hear about spare parts shortages, distress at their high operational tempo, and the need for fighter aircraft modernization. But the conversation that followed was dominated, I have to say overwhelmed, by complaints about the Department's health care program, TRICARE. They described difficulties making appointments, confusing coverage rules, delayed payments, and denied claims. They described anguished late-night telephone conversations with spouses and children calling from the other side of the world, pleading for help navigating the torturous TRICARE bureaucracy.

So when the task force vice chairman, Congressman Thornberry, suggested we focus our first hearing on inefficiencies in DOD health care, I concurred eagerly because wasted TRICARE dollars affect so much more than just the fiscal bottom line. Improving TRICARE claim processing and customer service improves the quality of life for millions of service members and their families. An efficient, responsive health care system contributes to military readiness and sustains morale. Military recruits need to be able to tell TRICARE success stories, not TRICARE horror stories.

When a prospective volunteer in today's competitive job market says, how is your health care plan, how is the DOD health plan, according to the General Accounting Office [GAO], TRICARE is too complex, but reluctant to standardize coverage rules for fear of further alienating an already diminishing pool of providers. The price of excess complexity is paid in scarce health care dollars as paper claims clog the system and fraudulent vendors manipulate the byzantine payment process to their advantage.

As the former chairman of an oversight subcommittee with jurisdiction over Federal health care programs, I am reluctant to cast the Medicare program as a role model of efficiency and responsiveness. In many ways, I think a comparison between claims processing costs in the two systems is apt, but TRICARE could emulate recent steps by the Medicare program to streamline claims through electronic processing, standardized vendor identification numbers, and systematically review high-risk claims for fraud. DOD should also evaluate the benefits of joint purchasing and closer integration with the Department of Veterans Affairs, VA, health programs.

I look forward to the testimony of our witnesses this morning on these important issues and also welcome our colleague, Mr. Buyer, who is clearly in the center of this issue, as well as Mr. Spratt, who has always been a constructive force on this Budget Committee.

Mr. THORNBERRY. I now recognize the distinguished ranking member of the full committee and member of the Armed Services Committee, the gentleman from South Carolina.

Mr. SPRATT. Thank you, Mr. Chairman, and thank you for convening this important hearing. I would like to welcome our three distinguished witnesses, Dr. Sears from the Department of Defense, Steve Backhus from the GAO, and William Meyer, Palmetto Government Benefits Administrator—a long name, but a very important company with a very, very impressive record of insuring stewardship in the management of our health care assets, both in Medicare and in TRICARE.

This particular hearing will focus on TRICARE, and I think that is extremely important. It is an important program that is not working as well as it should and must, and there are a number of problems with it and one is the cost of processing claims. The cost of processing claims for TRICARE exceeds the amount that we pay for Medicare and we need to know why. I think it has something to do with the implementation of the whole TRICARE program. I rather suspect that we have underestimated the cost of the TRICARE program providing the quality of care that our service members not only have a right to expect, they have earned the right to that kind of care.

And furthermore, as we have tried to in the Congress improve TRICARE, we have probably increased the burdens, the demands upon this particular system. If the House proposal which we have passed in the defense authorization bill goes through or if the Senate proposal goes through, for example, in the Senate, they are proposing that all retirees have the option once they are in TRICARE, TRICARE Prime, of staying in TRICARE Prime past the age of 65. I think they should have that right. I think they earned that right. But if that happens, that is nearly two million additional retired service members who will be imposing additional demands upon the system and we need to know, are we adequately providing for the administration of this system? Why does it cost so much to process these claims?

Mr. Meyer, I think you will tell the committee today that your organization at times has had its own substantial backup with the Department of Defense where you have processed numerous claims and had outstanding receivables for the payment of U.S. services that simply have not been paid in a timely fashion by the Depart-

ment of Defense. We need to get to the bottom of this if we are going to get to the bottom of the problems of TRICARE, and I think this is critically important.

I am delighted we are having this hearing. I have a much, much longer statement which I think is pertinent but I will not try the patience of the committee. Let us get on to the substance of it. Mr. Chairman, I would like to offer this for the record.

Mr. THORNBERRY. Without objection, any written statement members would like to make will be made a part of the record.

[The prepared statements of James Moran, Paul Ryan, and John Spratt follows:]

PREPARED STATEMENT OF HON. JAMES P. MORAN, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF VIRGINIA

Mr. Chairman, I want to thank you for scheduling today's hearing on TRICARE claims processing. I look forward to the testimony of our witnesses and greatly appreciate your willingness to allow me to submit my statement for the record.

As you know from my involvement on this Committee and on the Defense Appropriations Subcommittee, providing quality, affordable health care for our nation's military personnel, their families and retirees is an issue I have followed closely during my years in Congress.

It is especially important now as we grapple with difficulties in recruitment and retention of our military men and women. It is critical that this Congress not only provide adequate health care for our active duty personnel, but that we ensure that our nation's military retirees—especially the 1.4 million Medicare-eligible military retirees—have more health care options.

In the past few Congresses, I have introduced legislation granting Medicare eligible military retirees the option of participating in the Federal Employees Health Benefits Program. I introduced the Health Care Commitment Act because I am deeply concerned that military retirees, particularly once they become eligible for Medicare, are being denied access to health care. Medicare-eligible retirees are denied access to CHAMPUS. They are prohibited from participating in TRICARE. They are also effectively shut out of military medical treatment facilities because they are placed last on the priority list for receiving care.

In effect, we have created a system where military retirees, once they reach the point in life where they need health care the most, are given the least from their former employer. This does not happen in the private sector and does not happen to Federal civilian retirees. Having a large number of constituents who are military retirees, I am familiar with the enormous difficulties that many retirees experience in accessing affordable health care, especially at a time when they need it most.

I have worked with Congressman Spratt, Shows, Norwood and Cunningham, among others, on a variety of legislation aimed at providing better care for military retirees over age 65. The budget resolution offered by House Democrats was the first vehicle considered on the House floor this year to address this issue and include \$16.3 billion over 10 years to improve health care for Medicare-eligible military retirees.

While we could spend an entire hearing on health care options for our nation's military retirees, this hearing will concentrate on TRICARE claims processing.

In hearings held earlier this year by the Military Personnel Subcommittee of the House Armed Services Committee, there were several stories of unacceptable delays in TRICARE claims processing. In some of these cases, providers turned to the military beneficiary to seek payment for services rendered. This frustrates many service members and is a burden in particular for those that are deployed overseas. Even worse, as the service members tried to get TRICARE to pay and the bill went unpaid, the credit ratings of some service members suffered. So, prompt payment of claims is directly linked to quality of life and the morale of our troops.

While today's hearing will touch on the quality of claims processing, it will mostly focus on the cost of TRICARE claims processing. The Military Processing Subcommittee received testimony that the average cost of processing a TRICARE claim was between \$8.00 and \$15.00. Even the lower end of this range is substantially more than what it costs the Health Care Finance Administration to process Medicare claims.

It is my understanding that we will hear testimony today that the delays in claims processing occurred primarily in the mid-1990's when TRICARE was first

being established and that the most recent surveys indicate that TRICARE contractors are meeting or close to meeting the major deadlines for claims processing.

While I expect that witnesses today will also testify that many of the criticisms of TRICARE processing costs are inflated or based upon unfair comparisons to less complex claims, it is my hope that we can all agree that more can be done and commit to making TRICARE more user friendly and efficient.

Thank you for this opportunity to discuss such an important issue to our nation's 8.2 million active duty personnel, their dependents, and retirees. I look forward to hearing the testimony of our witnesses and any recommendations on how we can continue to improve the current system in order to achieve greater efficiencies and cost-savings.

PREPARED STATEMENT OF HON. PAUL RYAN, A REPRESENTATIVE IN CONGRESS FROM
THE STATE OF WISCONSIN

Mr. Chairman, I would like to bring some inefficiencies of the TRICARE system to the attention of the members of the Task Force. Many of my constituents rely on TRICARE for their health care services—yet this program has repeatedly proven to be inefficient and ineffective, leaving my constituents and I with little recourse.

TRICARE is a regionally managed health care program for active duty and retired uniformed service members and their families. According to their website, TRICARE is being implemented as a way to: provide faster, more convenient access to civilian health care; create a more efficient way to receive health care; and control escalating costs.

In my experience with TRICARE, this has certainly not been the case. There have been a number of cases where I have assisted constituents who had problems with TRICARE, of which two took over 5 months to resolve.

The first case had over 20 claims submitted that were either paid incorrectly or not processed by TRICARE before the constituent contacted our office. When my office inquired as to why this was the case, TRICARE stated that clerical error was the cause of a number of the errors—for example, registering the health care expense as \$10 instead of \$100. TRICARE could not explain why the remaining claims were not processed.

Another case showing the inefficiencies of TRICARE included a situation where thousands of dollars in claims were processed incorrectly by TRICARE because Region 5 was not aware of changes in Federal law under the National Defense Authorization Act for FY '99. P.L. 105-261 was Federal law for more than a year prior to my inquiry. TRICARE repeatedly denied claims because of this—even during our inquiry.

These are just two examples of how the current TRICARE system has let down constituents in Southeastern Wisconsin. I have dealt with this program in countless other cases and I have found similar results.

I commend Chairman Shays and the Task Force for looking into this very real and pressing problem in our armed services today. Our military personnel deserve better health care than they are presently receiving and taxpayers should not be forced to pay for these inefficiencies.

Our service men and women should not have to wait 5 months to settle their health care claims. I look forward to working with you, Mr. Chairman and members of this Task Force, to put an end to this.

PREPARED STATEMENT OF HON. JOHN M. SPRATT, JR., A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF SOUTH CAROLINA

I want to thank you, Mr. Chairman, for convening this hearing, and welcome our three distinguished witnesses: Dr. James Sears, from the Department of Defense; Stephen Backhus, from the General Accounting Office; and William Meyer, of Palmetto GBA, from my own state of South Carolina.

This hearing is about one aspect of DOD health care, but I want to use this opportunity to make a larger point: we must provide better health care for military retirees once they reach age 65. I serve on both the Budget Committee and the Armed Services Committee, and I hear a lot about how military retirees are no longer encouraging young people to enlist. This red-hot economy is making recruitment and retention difficult enough. We do not need more disincentives to military service. General Henry Shelton, Chairman of the Joint Chiefs of Staff, agrees. He testified that guaranteeing lifetime health care is important not only to keep the promises made to those who dedicated their careers to military service, but also to attract and retain good people today. Providing health care to military retirees age 65 and over is an issue this Congress should tackle this year.

Today's hearing is on TRICARE claims processing. TRICARE is the Department of Defense's health care system. It is called TRICARE because it offers three options; an HMO option, a preferred-provider option, and a fee-for-service option. TRICARE uses a network of civilian health care providers to complement the DOD's own hospitals and clinics to provide health care to active-duty personnel and their dependents, and eligible military retirees and their dependents.

Currently, TRICARE is not available to military retirees who are eligible for Medicare. So when military retirees turn age 65, they can no longer obtain TRICARE. Since the military has downsized and the population of military retirees has grown and is still growing, it is difficult for most retirees over age 65 to get treatment at military facilities, even on a "space-available" basis, which is the only health care option now open to them. These retirees spend much of their adult lives in the military health care system, and get to know the doctors at the base and in the network where they retire. Then they turn 65, and in most cases, they have to establish new relations with new doctors at an age when continuity of care is extremely important.

The budget resolution offered by House Democrats was the first vehicle considered on the House floor this year to address this issue. We included \$16.3 billion over 10 years to improve health care for Medicare-eligible military retirees. In part because of the impetus of the Democratic budget, the House and Senate Defense Authorization bills both propose extending DOD health care to military retirees, but do so in different ways. The House bill proposes expanding Medicare Subvention, where Medicare reimburses DOD for providing health care to Medicare-eligible military retirees, much as it reimburses private sector health care providers. Rep. Gene Taylor offered this provision as an amendment on the House floor. The Senate bill would allow military retirees age 65 and older to stay enrolled in TRICARE.

TRICARE is the successor to Civilian Health and Medical Program of the Uniformed Services, or "CHAMPUS." It began in the mid-1990's, and frankly, it has had growing pains. One of the growing pains is claims processing. There have been stories of claims being held up for long stretches of time. In these cases, some providers have turned to the military beneficiary to seek payment for services rendered. This frustrates many service members, and if you are overseas on deployment, it can be a real headache to deal with. Even worse, as the service members tried to get TRICARE to pay and the bill went unpaid, the credit ratings of some service members suffered. So, prompt payment of claims is directly linked to quality of life, and when we have trouble recruiting and retaining our soldiers, sailors, airmen, and marines, this is important.

Today we will likely receive testimony that there have been improvements in the quality of claims processing, and so we will focus even more on costs. There have been allegations that TRICARE is inefficient in processing claims in comparison to Medicare. In truth, TRICARE claims do cost more to process. This hearing will explore why that is, and what steps can be taken to reduce the cost of TRICARE claims management.

This is important for several reasons. First, the less we have to spend on claims processing, the more we have to spend on health care. I am from South Carolina and I represent Shaw Air Force base. I can tell you that TRICARE has a hard time signing up providers in my state. If we had more money to offer, we could induce more providers into the TRICARE network. In addition, the more we can standardize forms to make them easier to process, and the better TRICARE is in making prompt payments, the more doctors we can attract. This will make life better for active duty troops, eligible military retirees, and the families of both. TRICARE processed 32 million claims in 1999; if we could save \$2 per claim, we could have up to \$64 million more to spend on improving the TRICARE networks, particularly in areas like South Carolina.

Second, we may end up adopting the Senate provision to open up TRICARE to military retirees age 65 and older, and their dependents. That would bring in about 1.4 million eligible beneficiaries into the TRICARE system, and with them, many more claims. We have to get TRICARE claims costs down and make that process more efficient if we open up TRICARE to all military retirees.

The hearing today is just one subset of the DOD health care issue, but it is an important one. While claims processing has not gotten the attention that the question of health care for military retirees has gotten, it is part of the equation. If we can reduce costs here, it frees up resources sorely needed for our active duty troops and our military retirees. I look forward to the testimony of our witnesses.

Mr. THORNBERRY. The chair would now recognize the distinguished ranking member on the task force, the gentleman from Virginia, Mr. Moran.

Mr. MORAN. Thank you very much, Mr. Thornberry. Nice to see you. I want to thank you for scheduling today's hearing, Mr. Shays, Mr. Thornberry, and thank you, Mr. Buyer, for being here, and, of course, our ranking member of the full Budget Committee, Mr. Spratt.

This is an important issue. There are few more important issues than providing quality, affordable health care for our nation's military personnel, their families, and retirees, because unless we do it, the quality of our military capability is going to suffer greatly. This is one of the biggest issues in terms of recruiting quality personnel.

It is especially important now as we grapple with difficulties in recruitment and retention because the viability of the TRICARE system is in question. I probably get more complaints about military health care and TRICARE and retirees' health care than anything else. Now, that may partly be a function of my district, but I suspect that it cannot be a unique problem. There are 1.4 million Medicare-eligible military retirees and the Congress's attempt to provide adequate health care for them that is accessible and affordable has been one of the more controversial issues we have had to deal with.

In the past few Congresses, I have introduced legislation granting Medicare-eligible military retirees the option of participating in the Federal Employees Health Benefits Plan. I introduced a Health Care Commitment Act because I was concerned the military retirees, once they become eligible for Medicare, are being denied access to health care, given the fact that they do not have CHAMPUS available to them any longer. They are prohibited from participating in TRICARE and they are effectively shut out of the military medical treatment facilities because they are on the very bottom of the priority list for receiving care.

In effect, we have created a system where military retirees, once they reach the point in life where they need health care the most, are given the least from their former employer. We are the only large employer that does not provide health care as a benefit to its employees, that is, the Department of Defense military personnel.

Having a large number of constituents who are military retirees, I can relate to their problems and I think it is something that we are ultimately going to fix, but it is going to cost a great deal of money. The bill that was most recently considered on the floor that was sponsored by Mr. Spratt, Mr. Shows, Congressmen Norwood and Cunningham, as well, would have cost \$16 billion over 10 years.

We can spend an entire hearing on health care options for retirees, but this is going to be primarily on TRICARE claims processing. There have been unacceptable claims in the claims processing for TRICARE. It has frustrated many service members and it is a particular burden for those deployed overseas. Even worse, as the service members tried to get TRICARE to pay and the bill went unpaid, the credit rating of many service members suffered. So prompt payment of claims is directly linked to the quality of life and morale of our troops.

While today's hearing will touch on the quality of claims processing, it will also focus primarily on the cost of that processing. The

Military Personnel Subcommittee received testimony that the average cost of processing a TRICARE claim was between \$8 and \$15. Even the lower end of this range is substantially more than what it costs the Health Care Financing Administration, HCFA, to process Medicare claims.

It is my understanding that we are going to hear testimony today that the delay in claims processing occurred primarily in the mid-1990's, when TRICARE was first being established, and that the most recent surveys indicate that TRICARE contractors are meeting or close to meeting the major deadlines for claims processing. I suspect the witnesses are also going to testify that many of the criticisms of TRICARE processing costs are inflated or based upon unfair comparisons to less-complex claims.

I hope we can all agree that more can be done and that we will commit to making TRICARE more user friendly and efficient. It is as important an issue as there could be to the 8.2 million active duty personnel, their dependents, and retirees, and so I am glad we are having the hearing. With that, I will conclude my statement. Thank you, Mr. Chairman.

Mr. THORNBERRY. Thank you.

The chair recognizes the gentleman from Indiana, Chairman Buyer, for any comments you would like to make.

Mr. BUYER. Thank you, Mr. Chairman, for the courtesy extended by inviting me to participate with you and other members during the examination of the cost of TRICARE claims processing. I also appreciate the kind remarks you extended to the Military Personnel Subcommittee of the House Armed Services Committee on the whole area of military health care benefits. There are very real and tangible benefits from the excellent bipartisan working relationship Mr. Abercrombie and I enjoy.

With regard to comments by the ranking member, Mr. Moran, he is very accurate in describing the 1.4 million retirees. We have to be very careful, I would say, in our language about what occurred on the House floor with regard to Mr. Taylor's bill with Medicare subvention, because the reality is we only have so much limited space, we only double the number covered by the Medicare subvention program from 30,000 to 60,000. So there is this unreal expectation out there among the force that I am going to be deriving a very real benefit and it is not going to be there.

We are going to work through this one, though. That is the good story here. And Mr. Spratt's comment about moving toward what the Senate has done, the Warner provision of saying when you turn 65, you really sort of stay in the TRICARE that you have, I am moving toward my own personal belief, having worked on these issues now for 8 years, that I do not believe anything magically should happen to a soldier when they turn 65. Now, I know that there are some members who are really concerned that we did not have this vote on FEHBP. We need to be very careful about how we conduct our business here.

So, Mr. Spratt, I enjoyed your comments on that because I think that is probably where we will end up going. The more we telegraph to whoever the next administration is going to be that when we put our arms around this one, the key here is that in 2003 as we prepare for the 2004 budget, there is going to be a large bill

that could be \$8 to \$10 billion. So I enjoyed the gentleman's comments.

The defense health program represents over \$17 billion of the Department of Defense budget. About \$4.7 billion of that now purchases care in the private sector through the TRICARE program. Included in the cost of the private sector care is the cost of the claims processing, which is estimated at \$270 million.

Mr. Chairman, despite the fact that we already spend \$17 billion a year on the Defense health program, the program is by some estimates underfunded, so I would say, Mr. Spratt, you are completely accurate. The GAO, even though the DOD does not like to admit it, they are saying that it is by at least \$6 billion over the next 5 years, so that is a stunning number.

As a matter of fact, I want to share this with the Budget Committee, and this is completely another hearing. I believe that there is a problem in the modeling that the Department of Defense uses for the estimates of what their budgets should be. We have told them that year after year, but we still have those problems. So I just wanted to bring that to your attention.

We need to invest our resources in purchasing benefits, not unnecessary administrative costs. We should also ensure that savings we achieve should be plowed back into this chronically underfunded program. The TRICARE claims processing system has lagged behind the health insurance industry. It frustrates our TRICARE contractors. It also lags behind Medicare in moving to more efficient claims processing, as all of you have said in your statements.

I had directed that copies of several white papers that I have requested from not only the TRICARE managed support contractors but also that of the director of the TRICARE management activity, who we will be receiving testimony here today, were made available to the committee. These papers describe the faltering claims process that is in great need of modernization. In fact, our analysis indicated we might be wasting over \$100 million a year as a result of the inefficient claims processing systems.

During our hearings on removing the barriers to TRICARE, we received testimony from TRICARE providers, claims processors, beneficiaries, managed care support contractors and the TRICARE management agency and lead agents. We learned in our hearings that there was a broad agreement among these different stakeholders that the system as it now exists is outdated and inefficient. Too many providers claim that they are not being paid in a reasonable period of time. The administrative requirements go far beyond what other governmental systems, like Medicare, require. As a result, far too many providers either never become participating providers or they end their active participation with TRICARE. The managed care support contractors have had to operate in a claims processing environment one of them has described during the committee hearing as "the best Model-T money can buy."

Mr. Chairman, we can do better and I think the Fiscal Year 2001 National Defense Authorization Act goes a long way in resolving some of these concerns. I will not use a lot of my time detailing all the specific actions that we have taken, but in summary, we directed several very specific actions to improve claims processing

and other business practice improvements to streamline and make user friendly all the TRICARE administrative systems.

One of the lessons we learned in the white papers is the cost per claim and chance for errors are increased whenever a claim is manually processed. The more these systems can be automated, the more efficient they become. As a result, costs and costly errors are reduced through the whole system. Therefore, most of our initiatives were designed to facilitate improving or expanding automated claims processing in TRICARE. You can imagine the example of a doctor who wants to track a particular claim. He actually speaks to a person, and the more that person handles it, the more time is invested and it just escalates the cost.

Mr. Chairman, the Fiscal Year 2001 National Defense Authorization Act, we picked much of what I would call the lower hanging fruit in our efforts to improve the TRICARE claims processing. However, I am confident that there are more opportunities for improvement, so I applaud the Budget Committee for choosing this as one of your subject areas to investigate.

Ferretting out waste or abuse wherever it can be found is wise. It is part of why we are here to serve, to make sure that we spend our limited resources in the right way and exercise good judgments to move toward good government principles. I appreciate the opportunity to participate in this hearing and look forward to continuing to exchange information with our witnesses we have here today, and let me extend compliments to them because I enjoy the working relationship which we have put together on the National Defense Authorization Act, and I yield back my time.

Mr. THORNBERRY. I thank the gentleman for his statements.

I trust the witnesses get a feel for the importance members place on the military health care system and some of the frustrations we feel if money is being used in a way that is not as efficient and not as it is intended to be used.

Without objection, each of you can submit written statements or whatever written materials you would like and they will be made part of the record.

We will first hear from the senior leadership of the Defense health program, Dr. James Sears, Executive Director of the Department of Defense TRICARE Management Activity. Then we will hear from Mr. Stephen Backhus, Director of Veterans' Affairs and Military Health Care Issues for the General Accounting Office. Then we will hear from Mr. William J. Meyer, Senior Vice President for TRICARE, Blue Cross-Blue Shield of South Carolina.

Dr. Sears, you may proceed.

STATEMENT OF H. JAMES T. SEARS, M.D., EXECUTIVE DIRECTOR, TRICARE MANAGEMENT ACTIVITY, DEPARTMENT OF DEFENSE

Dr. SEARS. Thank you, sir. Your concerns are ours.

Mr. Chairman, distinguished members of the task force, I appreciate the opportunity to be here today to discuss the Department's progress in improving claims processing, timeliness, and accuracy, while at the same time implementing initiatives to reduce the costs associated with adjudicating claims.

Before I address the issues, I want to acknowledge the support and positive working relationship we have with the House Armed Services Committee, with Mr. Buyer and his committee members, some of whom are on this task force. I also want to thank Representative Moran for his support as a member of the Defense Appropriations Committee.

Oftentimes, the cost of adjudicating TRICARE claims is compared to that of Medicare. Unfortunately, the two programs are not comparable entities. By definition, Medicare is a single fee-for-service program. TRICARE is a triple-option managed care program. Managed care, by definition, is designed to assure the efficient use of health care dollars. Ensuring this, however, requires the expenditure of administrative dollars. Perhaps an example will help.

We recently discovered in one of our regions a rate for caesarian sections that was six times the national average. Through effective utilization management techniques, including preauthorization and retrospective clinical claims review, we have successfully changed practice patterns and improved the quality of care for this procedure in that region, while concurrently reducing health care costs by approximately 50 percent. This, however, minimally increased our administrative cost to conduct these clinical reviews.

On the other hand, our work simplification and claims re-engineering initiatives revealed that the utilization management effort associated with prenatal ultrasounds associated with these deliveries were resulting in the verification that these procedures were, in fact, being delivered appropriately. This led to our elimination of the government requirement to clinically review ultrasounds and the savings of associated dollars.

Other differences between TRICARE and Medicare include the sheer number of citizens served by Medicare compared to the relatively small number of TRICARE beneficiaries. While Medicare processes nearly 900 million claims a year, TRICARE's 32 million claims annually do not provide the economies of scale Medicare enjoys. Our relatively small volume, especially as compared to Medicare, and far more comprehensive program, inhibits our ability to dictate the business practices of the provider community.

The volume differences between TRICARE and Medicare also significantly impact our ability to achieve the same level of electronic submissions as Medicare. Our providers typically submit fewer than 10 TRICARE claims a month. Conversely, Medicare typically accounts for as much as 50 percent or more of a provider's income. There is simply no return on investment for small volume providers to invest in systems capable of submitting TRICARE claims when over 95 percent of our claims are paid within 30 days. Again, HIPAA, once implemented, will eliminate this issue and result in a dramatic increase in the receipt of electronic claims.

Over the last 2 years, the Department has been actively involved both independently and with the assistance of our contractors in reviewing the government's processes for adjudicating claims, with an eye toward balancing customer service with costs. These initiatives began with an effort we called work simplification. Through this process, the government partnered with our current contractors, who identified roadblocks to prompt and efficient claims processing. We identified a considerable number of impediments, in-

cluding mandated medical reviews, paper documentation, and other program complexities that inhibited the processing of claims.

We have issued two comprehensive changes as a result of this initial effort that remove the vast majority of these impediments and that, when fully implemented, will allow claims to adjudicate without human intervention. We used caution when implementing these initiatives. Each impediment to claims processing was weighed against the potential impact on health care dollar expenditures.

For example, removing medical review requirements and the requirement for the associated documentation subjects the government to excessive utilization and expenditure of finite health care dollars and the potential for fraud and abuse.

Conversely, our overemphasizing review processes increases the cost and time involved with processing of a claim. Working with our contractors, we are carefully reviewing every aspect of the health care financing and delivery system to determine where statistical sampling is more appropriate than individual case review, where case review is resulting in no savings, and where profiling will identify instances where the Department can focus on a very limited number of procedures or providers to ensure that health care dollars are not unnecessarily expended.

In conjunction with these efforts, the government is moving forward to implement the electronic submission of as many claims as possible. This is being done through the implementation of web-based technology and an emphasis on electronic claims submission, using Medicare's electronic submission requirements and encouraging our providers to submit their claims electronically in all of our education and marketing materials.

Electronic submission can gain us several benefits, equating to approximately \$2 per claim. More importantly, electronic submission is a tremendous benefit to our providers in that simple clerical errors are detected immediately and corrected without delay. These electronic submissions also feed the provider's business systems to reduce the doctors' administrative costs.

From a claims processing perspective, these systems eliminate the need for our contractors to retype information. They eliminate keying errors. They substantially increase the number of "clean claims," and they allow claims to process in a fully electronic environment. While these substantial benefits accrue to the government, we also recognize savings in the area of filing and storage the vast amount of paper associated with manual claims processing.

Unfortunately, these efforts are not the panacea and we have much work left to be done before achieving a position where all provider-submitted claims are electronic. TRICARE alone has achieved an electronic submission rate that is nearing 50 percent. However, the Congress in legislating the Health Insurance Portability and Accountability Act, has provided the health insurance industry with the single most important tool for reaching our goal of 100 percent electronic claims submission. This tool, a standardized format for the data elements and the transmission format, will unify the entire industry and make the electronic submission of

claims the only practical business process available to the provider community.

We are looking forward to the publication of the HIPAA rules by HHS and the mandated effective date 2 years hence. In the interim, we are working very closely with our contractors and have implemented the first phase of web-based technology. These current systems allow our beneficiaries online access to their claims status and history. Each electronic web-based inquiry eliminates the need for a telephone call, including the associated staffing facility and infrastructure costs. We are rapidly expanding this technology and anticipate including physician access in the very near future as security and privacy issues are resolved.

As we are able to open these communication pipelines to all of our clients, our client satisfaction will increase while the government cost per claim will decline in future contracts.

Shifting gears, I would like to briefly address the issue that some of our beneficiaries are being pursued by collection agencies. While the number is extremely small, we are very concerned with each and every instance. All of our TRICARE contractors have established special units designed specifically to resolve collection issues. In addition, at each of our lead agents, we have created positions solely responsible for assisting our beneficiaries with whatever they require. We have expanded this function and created similar positions at each of our military treatment facilities to provide dedicated onsite assistance. I recognize that we can never guarantee that a single beneficiary will not be subject to collection. However, DOD is now in the position of being able to provide dedicated personal assistance and resolution to any problem that arises.

Finally, I wish to conclude with a word of caution. The key to reducing claims costs is to pay claims without human intervention. This is not without cost. We must carefully balance fully electronic claims payment with ensuring that taxpayer dollars are only expended for medically necessary and appropriate care, and as we progress in these efforts, claims costs will be reduced, but they will continue to contain those costs associated with ensuring the proper expenditure of government resources. We must also never forget service to our military men and women and the doctors who provide their care. This, too, is not without cost. However, the value of serving our beneficiaries cannot be understated.

I sincerely appreciate the time this task force has provided for me to briefly explain TRICARE claims and claim costs. I am at your disposal to expand on my comments and answer any other questions that you have.

Mr. THORNBERRY. Thank you, Dr. Sears.

[The prepared statement of H. James T. Sears, M.D., follows:]

PREPARED STATEMENT OF H. JAMES T. SEARS, M.D., EXECUTIVE DIRECTOR,
TRICARE MANAGEMENT ACTIVITY

Mr. Chairman, distinguished members of the committee, I appreciate the opportunity to discuss the Department's progress processing TRICARE health care claims in the Military Health System.

My testimony today will focus on the steps we have taken to reduce the costs associated with processing TRICARE claims. First, I would like to report on two standards that have helped the Department make significant progress in claims processing timeliness.

Beginning in October 1999, TRICARE removed barriers to electronic claims submission and moved to claims processing timeliness standards similar to those used by Medicare. The new standards, effective October 1999, require our Managed Care Support Contractors to process 95 percent of accurately submitted claims within 30 calendar days from the date of receipt of the claim and payment errors may not exceed 2 percent. We have exceeded this standard in five of the last 7 months (in December 1999 and January 2000, 2 months where the standard was not met, the average was 94.4 percent). Our most recent information for March and April 2000, shows that our contractors exceeded the 95 percent standard by processing 97.5 percent of all accurately submitted claims within the 30-day standard.

The second standard requires contractors to process 100 percent of accurately submitted claims within 60 days of receipt. We continue to strive to meet this standard, however, for the most recent 2 months, we processed 99.6 percent of claims within 60 days. This extremely high level of performance will result in an ever-increasing number of satisfied providers who will submit more accurate claims either by mail or electronically. Accurate paper and electronic claims significantly reduce the manual intervention required in the adjudication process and equate to reductions in the overall cost of processing a claim.

These ongoing initiatives have resulted in dramatic increases in the prompt adjudication of claims mentioned previously and, as improvements continue to be realized, will result in further reductions in the cost of adjudicating TRICARE claims. We will continue our efforts to simplify requirements and reduce costs. When comparing our claim costs to those of Medicare, it is important to remember that there are significant differences between the two programs. Claim costs for TRICARE include a number of functions that are not included in Medicare claim costs. TRICARE claim costs include additional functions such as appeals, customer service, beneficiary and provider education, and coordination of benefits. In addition, for most Managed Care Support Contracts, the prime contractor uses the claims processing subcontractor's enrollment and utilization review systems, and those costs are reflected in the claim rate. There are also statutory requirements that increase complexity (and therefore cost). These include the three-tiered benefit structure for TRICARE (Prime, Extra, and Standard), differing copayments and catastrophic caps depending on rank or service status. They also include mandated special programs such as the Continued Health Care Benefits Program, TRICARE Senior Prime, and Base Realignment and Closure (BRAC) pharmacy benefits.

Further, while we expect that managed care will reduce health care costs overall, there are additional administrative tasks that accompany these reduced health care costs. These include the more extensive use of pre-authorizations and referrals that must be coordinated with claims. There is also significantly more effort in maintaining provider data. For example, the claims processor must track who is in the network and what the negotiated rate is for each service. This may vary even within provider groups or clinics, and network tracking and updates requires significant effort.

An example of managed care's impact on health care costs is the Pharmacy Data Transaction System (PDTS). The database will incorporate prescription data from retail networks, from the Department's National Mail Order Pharmacy program, and from pharmacies at Military Treatment Facilities. Each of these prescription sources will have an electronic connection to the national database.

PDTS will allow instantaneous checks for adverse drug reactions or duplicate prescriptions. It will also help prevent over-utilization and drug abuse by giving visibility of prescription drug usage across the Military Health System. The PDTS checks will occur at Point-of-Sale, allowing immediate patient intervention and education.

We expect to begin implementation of PDTS this summer, starting with the Managed Care Support Contractors' retail networks.

Over the past few months, the health care industry, like other industries, has been moving toward changing the way health care business is conducted. Health plans, providers, employers, health care consumers, and other health care-related businesses are adopting and applying new electronic technologies at great speed. Congress recognized the efficiencies and cost-savings that can be realized through electronic data interchange (EDI) and the application of standards in conducting health care business electronically, and passed the Health Insurance Portability and Accountability Act of 1996 (HIPAA). The HIPAA statute requires the Secretary of Health and Human Services to adopt standards for financial and administrative transactions to enable health information to be exchanged electronically. These standards apply to the entire health care industry including the Military Health System. The first of these standards, those applying to electronic transactions and code sets, is expected to be published in a final rule in August, 2000. If published

as expected, the standards become effective in August 2002. The TRICARE Management Activity is committed to and actively working toward achieving full compliance with all HIPAA standards within the required time frames.

While the health care industry awaits the publication of the HIPAA standards and requirements, it is not waiting to develop and implement other e-commerce and web-based business applications and solutions. TRICARE isn't waiting either. The Department is actively reviewing all facets of its business practices and operations and is identifying those that can be moved to and performed on the Internet. Managed Care Support Contractors and their claims processing subcontractors are developing web sites on which beneficiaries and providers will be able to look up the status of their claims, submit enrollment applications, update addresses and other demographic data, submit health care questions, request authorizations and referrals, and conduct other health care related business. The Department has been working on the development of the electronic health care record with new versions of Defense Eligibility and Enrollment Reporting System (DEERS) and the Composite Health Care System (CHCS) which should ultimately allow for greater access by providers, beneficiaries, the Military Health System, and TRICARE business partners and contractors. The development of TRICARE data warehouses and of powerful data mining applications should provide DoD with valuable new health care information on which business decisions can be made and health care delivery improved for our beneficiaries.

The speed with which technology is evolving and being adopted by the health care industry requires that organizations evaluate and re-think how business is conducted. Health care consumers, our beneficiaries, are becoming computer-savvy and are demanding the kind of improved health care services that can be delivered today. The Department is actively working toward meeting their expectations and the expectations of the health care industry as a whole. The result of electronic commerce is the elimination of high cost human intervention which directly correlates to reduced claims processing costs.

The Department has developed TRICARE Encounter Data (TED) records to replace Health Care Service Records (HCSRs). These records are simply processed claims data that are submitted to TMA in a standardized format. The TED record has evolved from the Health Care Service Record (HCSR) to a more streamlined and "user friendly" format. Claims processors use proprietary systems for processing TRICARE claims. The outputs from these claims processing systems are in different formats and contain different data elements and values. The Military Health System needs a centralized database of processed claims and encounter data for financial and program management purposes. In order to centralize the data and incorporate it into a single database, it must come into the Department in a consistent format. The TED record prescribes a much easier standardized format for contractors to submit claims data that will further reduce administrative costs when adopted.

TED records allow us to apply rules and edits that help ensure that the claims and encounter data being submitted is accurate and reliable. Without the ability to establish rules and apply edits, financial and other important business decisions may be based on erroneous information with significant financial consequences.

As an alternative to TEDs, The Department is evaluating contractor proposals to eliminate TEDs altogether. Under this proposal, contractors would submit claims data to their own data warehouses to which they would allow DoD access. As part of our evaluation, we are looking at overall program costs to shifting from TEDs to a raw claims data-warehousing model.

For now, TED records should reduce costs over those previously associated with HCSRs and permit us to perform audits and monitor contractor performance. They can be used in bid price adjustment calculations and allow the development of reliable claims volume projections for procurements. They enable us to identify and recoup duplicate claims payments where one claim is paid by a contractor and the same claim is paid by another. They will continue to enable us to identify, account for and audit at-risk and not at-risk claims payments. Until a viable and even more cost-effective alternative emerges, TED records will support TRICARE management and provide better and easier access to claims data across the enterprise at reduced cost.

I am extremely pleased with the significant progress that has occurred over the last 2 years as a result of the joint efforts of the Managed Care Support Contractors, TMA, the Lead Agents, and the Surgeons General to reduce claims costs and complexities. Working together, we have removed thousands of Government specified claims reviews, such as the clinical review of oxygen, ultrasounds, and CT scans. We eliminated prescriptive controlled development requirements, simplified the provider certification process and now permit the use of commercial best practices for

utilization management. Soon, we plan to simplify requirements for coordination of benefits and for third party liability collections. By removing Government mandated reviews, we have not only complied with the President's acquisition reform initiatives, but have created a 21st century environment that allows our contractors to employ their best commercial practices to the processing of TRICARE claims while concurrently reducing cost.

These initial claims improvements were complemented by a study the Department commissioned by First Consulting Group (FCG). FCG applauded the work completed to date and offered additional suggestions for enhancements. These included allowing our contractors to accept the Medicare provider number on electronically submitted claims and assisting the Department and our partners in the utilization of new world wide web based technology. These initiatives, when fully implemented, will eliminate much of the need for human intervention, the highest single cost factor in claims adjudication.

Improving the TRICARE claims processing environment is a continuous quality improvement process. Our MCS contractors continue to submit suggestions for improving performance and implementing new technologies. Working together, with all of our partners, we will persist in our efforts to obtain state-of-the-art processes and systems that achieve the highest quality of performance at the most reasonable and effective cost to the Government.

Mr. THORNBERRY. Mr. Backhus, as I mentioned, your full statement will be made part of the record and you may proceed to summarize it.

STATEMENT OF STEPHEN P. BACKHUS, DIRECTOR, VETERANS' AFFAIRS AND MILITARY HEALTH CARE ISSUES, GENERAL ACCOUNTING OFFICE

Mr. BACKHUS. Thank you, Mr. Chairman. Good morning, Mr. Chairman and members of the task force. I am pleased to be here today to discuss what DOD can do to reduce TRICARE claims processing costs, and as you requested, I will also briefly discuss the need for increased anti-fraud efforts and more joint purchasing of pharmaceuticals and medical supplies with the VA, both of which could reduce costs. Finally, I will discuss our ongoing study of the process beneficiaries use to make medical appointments. The information I am presenting is based on a substantial body of work we have undertaken over the past several years on TRICARE operations.

Today, TRICARE has much room for improvement. Each claim costs an average of \$7.50 to process, double the industry average and more than four times the \$1.78 for Medicare claims processing costs. These higher costs are attributable to a number of factors.

Over half of TRICARE's claims are manually reviewed, a rate significantly higher than the industry average of 25 percent. For example, claims submitted for electrocardiograms require manual review, but in every case so far, after review, these claims have been paid. Last year, for one TRICARE contract alone, there were almost 14,000 of these claims.

Furthermore, claim inquiry rates average about one for every four-and-a-half claims, four times higher than Medicare inquiries. These inquiries add substantial cost to the program.

But perhaps most significantly is that less than 20 percent of hospital and professional claims are submitted electronically, compared to the Medicare average of about 85 percent.

Obviously, we believe there is potential for reducing claims processing costs. The initiatives that DOD has underway and planned, some legislatively directed, if implemented properly, should go a long way toward reducing such costs. These include reducing man-

ual review requirements when they are unnecessary, promoting electronic claims submission, using automated voice response systems for provider inquiries, and adopting Medicare claims processing time limit standards. As a means of encouraging electronic claims submission, DOD is also permitting its contractors to delay payment of paper claims as long as overall time limit standards are met.

I need to caution, however, that the cost reductions from these and other efforts are limited and cannot be expected to approach current Medicare costs, primarily because TRICARE and Medicare are vastly different programs in terms of the benefit structure and size. For example, TRICARE's fixed costs are spread over a much smaller claims base than Medicare's and the TRICARE triple-option managed care benefit requires greater administrative costs than Medicare's fee-for-service plan.

I would now like to turn to opportunities for increased efficiencies in other TRICARE areas. DOD estimates that losses due to fraud and abuse could account for 10 to 20 percent of military health care expenditures. DOD could be more effective in combating fraud and abuse if the contractors were more proactive in identifying and referring potential fraud cases. Out of over 40 million claims processed from January 1999 through April 2000, only 17 potential fraud referrals from contractors have been accepted by DOD for investigation.

DOD would also benefit financially through additional cooperative efforts with the VA to procure pharmaceuticals and through the use of VA's mail outpatient pharmacy for their refill workload. The expectation is that as the two agencies buy more of a particular drug, their leverage, particularly under competitively bid contracts, would permit them to obtain even greater discounts from drug manufacturers and save money for both departments. We believe that VA and DOD could potentially save between \$150 to \$300 million more each year by jointly purchasing medications. An additional \$45 million could be saved annually if DOD used VA's mail outpatient pharmacy for their refills.

In addition to cost efficiencies, we are currently studying ways DOD could increase beneficiary satisfaction through changes to its medical appointment process. For years, beneficiaries have expressed frustration and confusion over how to access the health care system, largely because of the wide variability that existed in the appointment making process. Recently, DOD has been moving toward a centralized system that beneficiaries call to schedule all their appointments.

However, even this process appears to be confusing and frustrating to some beneficiaries because it is being implemented inconsistently. Some beneficiaries are transferred from the appointment center to a physician's office or clinic, some are told to call the office or clinic directly, and others get their appointments made as intended. Thus, what is meant to be a simplified, more user-friendly appointment process appears to still be a complex and confusing one, for beneficiaries are unsure who to call. We expect to be making recommendations at the conclusion of our work.

Mr. Chairman, this concludes my statement and I will be glad to answer any questions you or other members of the task force may have.

Mr. THORNBERRY. Thank you. I appreciate it.

[The prepared statement of Stephen P. Backhus follows:]

PREPARED STATEMENT OF STEPHEN P. BACKHUS, DIRECTOR, VETERANS' AFFAIRS AND MILITARY HEALTH CARE ISSUES, GENERAL ACCOUNTING OFFICE

Mr. Chairman and members of the Task Force, I am pleased to be here today to discuss opportunities to reduce claims processing and other costs of TRICARE—the Department of Defense's (DOD) managed health care program. Today more than 8.2 million active-duty personnel, retirees, and their dependents are eligible to receive care under this \$16 billion-per-year health care system. As the costs of delivering health care continue to increase and as beneficiaries demand improved and expanded services, significant pressures have been placed on the system, and DOD continues to search for ways to address them.

Since TRICARE's inception, we have reported on the challenges DOD faces in delivering health care. DOD considers health care to be one of its major quality-of-life issues important to maintaining a quality force. As a result, DOD has continually striven to deliver this health care benefit and to respond to suggestions made for improving its health care system. Currently, DOD is facing increasing pressures to improve customer service. Improvements in areas such as claims processing not only have the potential to make the health care system more user-friendly and efficient, but also to reduce costs.

At your request, my testimony today will focus primarily on the cost of processing TRICARE claims. Additionally, I will briefly discuss two other opportunities that potentially can reduce costs and improve service to beneficiaries, namely increased antifraud efforts and more joint procurement of pharmaceuticals and medical supplies with the Department of Veterans Affairs (VA). You also asked that I discuss our ongoing study of the process beneficiaries use to make medical appointments. The information I am presenting is based on a substantial body of work we have undertaken over the past several years on TRICARE operations.

In summary, processing TRICARE claims costs several times as much as processing Medicare claims—\$7.50 compared to \$1.78 per claim on average. However, much of the cost difference appears to be attributable to differences in program design and processing requirements. For example, TRICARE offers three different benefit packages, with reimbursement rates that are established for each provider, and a complex system of authorizations and referrals. The program also experiences frequent changes to coverage and operating policies that make it difficult to administer. Nonetheless, we and others believe that opportunities exist to reduce some of the approximately \$225 million spent annually to process claims. In response to the House version of the fiscal year 2001 Defense Authorization bill, and through several of its own initiatives that mirror private-sector practices, DOD has adopted and is planning several actions to reduce claims processing costs, including increasing electronic claims submission and web-based services to reduce the costs of claims review and to deal with the large number of inquiries received by providers and beneficiaries.

Beyond claims processing, we believe there are other opportunities to reduce TRICARE costs and improve services. For example, although DOD has efforts under way to combat health care fraud and abuse, these efforts have only been marginally effective. Additional opportunities exist to save potentially hundreds of millions of dollars that could be used to purchase care for military beneficiaries. Also, we believe that additional cooperation with the VA to procure pharmaceuticals and medical supplies could yield substantial savings. Lastly, different systems are in place throughout the military health system for making medical appointments, and beneficiaries sometimes are unsure as to how to make such appointments, leading to frustration with TRICARE. We are currently reviewing this process and anticipate making recommendations for improving it at the conclusion of our study.

BACKGROUND

DOD's primary medical mission is to maintain the health of active-duty service personnel and to provide health care during military operations. DOD also offers health care to non-active-duty beneficiaries, including dependents of active-duty personnel, military retirees, and dependents of retirees, if space and resources are available. The Army, Navy, and Air Force provide most of the system's care through their own medical centers, hospitals, and clinics, totaling about 580 treatment facilities.

ties worldwide. Civilian providers supply the remaining care. TRICARE is a triple-option benefit program designed to give beneficiaries a choice among a health maintenance organization (TRICARE Prime), a preferred provider organization (TRICARE Extra), and a fee-for-service benefit (TRICARE Standard).

TRICARE is organized geographically into 11 health care regions administered by five managed-care support contractors. Among the contractors' many responsibilities are claims processing, for which all have subcontracted with one of two companies. DOD requires contractors to meet specific timeliness and accuracy standards when processing claims. The tasks required to process claims include claims receipt, data entry, claims adjudication, and claims payment or denial. During 1999, contractors processed about 30 million health claims submitted by institutions, health care providers, and beneficiaries.

To help safeguard against health care fraud and abuse in its system, DOD established a Program Integrity unit in 1982 to coordinate its antifraud activities. This unit is responsible for developing policies and procedures regarding the prevention and detection of TRICARE fraud and abuse. DOD's Office of Inspector General and the Department of Justice work together with this unit (and sometimes also with the Department of Health and Human Services) to investigate and prosecute alleged health care fraud and abuse. DOD's contracts with its five managed-care support contractors also require them to perform antifraud and abuse activities to help ensure that TRICARE dollars are used to pay only claims that are appropriate.

PROGRAM COMPLEXITY IMPEDES CLAIMS PROCESSING EFFICIENCY; IMPROVEMENTS UNDER WAY

Claims processing activities have generated a great deal of dissatisfaction among providers and beneficiaries, as well as among various congressional committees, and DOD recognizes that problems exist. Complaints and frustrations stem from perceived inaccurate and late payments; complex program rules, processes, and reporting requirements; and high costs. All agree that the claims adjudication system needs to be simplified and made more user-friendly, and that it could benefit from increased use of technology. A number of administrative and legislative actions are under way, which, if properly implemented, should reduce TRICARE claims processing costs.

PROGRAM COMPLEXITY AND SIZE CONTRIBUTE TO HIGH CLAIMS-PROCESSING COSTS

In August 1999, at the request of the House Subcommittee on Military Personnel, Committee on Armed Services, we reported on the complexity of the TRICARE program and benefit structure.¹ This complexity manifests itself in many aspects of claims processing such as high rates of manual review, low electronic submission rates, and high customer inquiry rates. These factors, in addition to the relatively small program size when compared with Medicare, increase TRICARE claims processing costs because fixed costs are spread over a smaller number of claims. Currently, TRICARE claims cost an average of \$7.50 per claim to process—double the industry average and more than four times the \$1.78 Medicare claims processing cost.

Contractors told us that of the many programs they administer, including Medicare and private plans, TRICARE is the most complicated, contributing to claims processing difficulties and high costs. For example, each of TRICARE's three options has a different array of benefits, copayments, and deductibles. Claims require different adjudication procedures, depending on which option is involved, and contractual requirements for prepayment review further complicate the process. Complexities such as these are manifested as thousands of edits in the adjudication logic of the claims processing system. These edits result in claims being "kicked out" of the system for manual review, which extends processing time and increases administrative costs. Over half of TRICARE's claims are manually reviewed, a rate significantly higher than the industry average of 25 percent.

Program complexities also contribute to numerous beneficiary and provider inquiries, which add considerably to the cost of processing a claim. TRICARE claim inquiry rates average about one for every 4.5 claims—four times higher than Medicare inquiries. Documentation shows that beneficiaries frequently inquire about their benefits and cost shares because they do not understand the program. Providers inquire most often about payment issues primarily because the same services might be reimbursed at different amounts depending on which TRICARE option the beneficiary is using. TRICARE has thousands of unique fee schedules and contracts

¹Defense Health Care: Claims Processing Improvements are Under Way but Further Enhancements are Needed (GAO/HEHS-99-128, Aug. 23, 1999).

that change frequently. In contrast, Medicare reimbursement is more consistent because it has national standard physician and hospital payment methodologies. In addition, Medicare inquiries are handled almost entirely by automated systems.

TRICARE's per-claim processing costs are higher than Medicare's also because TRICARE's fixed costs are spread over a smaller claims base. Medicare costs are spread over about 900 million claims per year, whereas TRICARE processes only about 30 million claims per year.

Under TRICARE less than 20 percent of hospital and professional claims are submitted electronically, compared to the Medicare average of about 85 percent. Electronic claim submissions are faster, involve less chance of data input error, and are less expensive to process than paper claims. Paper-based claims require significant front-end handling in the mailroom, document preparation, imaging, data entry, and storage. However, because TRICARE is usually a small percentage of providers' income—often less than 5 percent—providers have no incentive to incur the expense of adapting their computer systems to permit electronic TRICARE claim submission. Furthermore, because 98 percent of claims are paid within timeliness standards, the incentive to submit electronic claims is further reduced.

Nevertheless, we believe that some opportunities exist to reduce the administrative costs associated with processing a TRICARE claim. One of the claims processing subcontractors reported that \$4.46 of each claim processed—totaling about \$125 million per year—is paid for services provided or processes required by the program above the costs of determining payment outcomes. For example, responding to TRICARE inquiries reportedly costs \$1 per claim more than responding to Medicare inquiries. Other costs that we consider to be targets of opportunity include mailroom handling, document preparation, imaging, paper storage, data entry, and certain reporting requirements. A number of initiatives are currently under way or planned that may reduce these costs as described below.

INITIATIVES UNDER WAY TO IMPROVE CLAIMS PROCESSING EFFICIENCIES

Several legislatively directed and DOD-initiated efforts are under way to simplify the claims adjudication process, improve provider and beneficiary education, and increase electronic claims submission. If properly implemented, these actions should reduce TRICARE claims processing costs.

For example, the House version of the fiscal year 2001 Defense Authorization bill would direct that the Secretary of Defense take action to require high-volume TRICARE providers to submit claims electronically, and increase the use of automated voice response systems for provider inquiries on claims status. Also, the bill would direct that certain administrative reporting requirements be reduced.

With the assistance of a consultant, DOD has developed and is implementing a plan that calls for eliminating unnecessary or duplicative processes that interfere with optimal performance, emphasizing the use of commercial best practices and Medicare standards. For example, the plan calls for adopting Medicare's standards for processing timeliness and the elimination of DOD required edits that should help decrease the number of manually reviewed claims. According to one of the claims processing subcontractors, some of these edits are unnecessary while others should be modified or retained. For example, claims for electrocardiograms must be manually reviewed, but in every case so far, the claims have been paid after review. Last year, for one TRICARE contract, almost 14,000 claims for this procedure were submitted. While DOD has issued formal contract modifications for all the changes it wants to make, contractors have not yet had time to implement all of them.

Additionally, DOD is pursuing the possible use of Medicare's provider identification numbers to encourage and facilitate electronic claims submission. Also, DOD now permits contractors to delay the payment of paper claims (as an incentive for providers to submit electronically) so long as the contractors continue to meet standards. This initiative mirrors Medicare's process for increasing the number of claims submitted electronically. Further, to reduce the number of manual reviews, DOD is encouraging contractors to limit prepayment review of certain types of claims if appropriate.

DOD and the contractors are also looking at ways to use new technology on the World Wide Web to reduce administrative costs and increase provider and beneficiary satisfaction. Currently, TRICARE claims processing subcontractors have developed comprehensive Web sites containing information on policy and benefits, electronic claims submissions, and claim status.² In addition, DOD and contractor

²One subcontractor's Web site (www.mytricare.com) allows beneficiaries to access claim status while the other subcontractor's site (www.upsic.com) gives providers access. Both sites are designed to ensure the privacy of beneficiary information.

officials are considering future use of the Internet as a means to submit claims for processing. This method, which is similar to that used for electronic claims, might provide a more expedient, less expensive means of handling claims. However, before this Web-based technology can be utilized, the government must define security requirements to ensure privacy.

Nonetheless, because TRICARE makes up such a small percentage of most providers' business, neither Web-based nor electronic claims submissions are likely to significantly increase in volume without specific incentives or mandates. However, mandates may increase providers' reluctance to participate in the program. In the future these problems may be mitigated as a result of industrywide requirements to adopt uniform standards for electronic health care transactions, including claims.³ Uniform standards for electronic claim submissions will enable providers to submit claims for any health insurance plan in the same filing format.

DOD COULD SAVE HUNDREDS OF MILLIONS OF DOLLARS WITH A MORE EFFECTIVE ANTIFRAUD PROGRAM

While DOD does not know the precise extent of fraud and abuse in its health care system, it estimates potential annual losses to its TRICARE program to be in the hundreds of millions of dollars. In addition to the financial loss, health care fraud and abuse also affects the quality of care provided and may cause serious harm to patients' health. Despite its responsibility to prevent and detect health care fraud and abuse, DOD has not been effective in doing so, recovering less than 3 percent of its estimated losses to fraud and abuse between 1996 and 1998. DOD has the opportunity to improve its antifraud efforts by developing clear and measurable goals and ensuring that contractors comply with the antifraud requirements in their contracts.

DOD estimates that losses due to fraud and abuse could account for 10 to 20 percent of military health care expenditures. These ranges are consistent with estimates of other public and private-sector organizations, such as the Health Care Financing Administration, the U.S. Chamber of Commerce, the Health Insurance Association of America, and the National Health Care Anti-Fraud Association. Given TRICARE's expenditure of about \$2.9 billion for contracted civilian-provided care in fiscal year 1999, DOD could be losing between \$290 million and \$580 million annually to fraud and abuse. DOD officials acknowledged that they could be more effective in combating fraud and abuse if their TRICARE contractors were more proactive in identifying and referring potential fraud cases. They also agreed that they should expedite the implementation of revised antifraud policies and requirements that place greater demands on contractors to identify and prevent fraud and abuse. However, although DOD provided contractors with antifraud software, not all contractors are using the software. Further, DOD required contractors to develop and submit antifraud plans, but most contractors' initial antifraud plans were deficient. Current statistics do not indicate any significant improvements in DOD's antifraud efforts. Out of over 40 million claims processed from January 1999 through April 2000, only 17 fraud referral cases from the contractors have been accepted by DOD for investigation.⁴

ADDITIONAL JOINT PROCUREMENT OF PHARMACEUTICALS WITH VA WOULD YIELD SUBSTANTIAL SAVINGS

We recently testified that DOD and VA would benefit through additional cooperative efforts to procure pharmaceuticals and through the use of VA's Consolidated Mail Outpatient Pharmacy (CMOP) for DOD's prescription refill workload.⁵ As the largest direct Federal drug purchasers, the Departments already enjoy varying, though significant, discounts on their drug purchases. The expectation is that, as the two agencies buy more of a particular drug, their leverage—particularly under competitively bid contracts—would permit them to obtain even greater discounts from drug manufacturers and to save funds for both Departments. Currently, the two agencies have awarded 18 joint and 51 separate national contracts representing 19 percent of their combined drug expenditures of \$2.4 billion in fiscal year 1999.

³The Health Insurance Portability and Accountability Act of 1996 (P.L. 104–191) requires the industrywide adoption of uniform standards for electronic transactions, including claims filing.

⁴These 17 cases all involved high dollars or had the potential to cause patient harm. In addition, contractors submitted numerous small dollar cases that DOD has returned, believing they should be handled as overpayments rather than as fraud.

⁵DOD and VA Health Care: Jointly Buying and Mailing Out Pharmaceuticals Could Save Millions of Dollars (GAO/T–HEHS–00–121, May 25, 2000).

We believe that VA and DOD could potentially save \$150 to \$300 million more each year by jointly purchasing other medications they both use.

Further, additional savings could be achieved by utilizing VA's mail-out pharmacy program to handle DOD's annual refill workload of about 23 million prescriptions. For example, VA has the capability for mail order refills through its CMOP and documentation shows that CMOP refills cost about one-half of DOD's current costs of refilling prescriptions at military pharmacies. CMOPs potentially could reduce military pharmacy refill dispensing costs by about \$45 million annually.

IMPROVING THE MEDICAL APPOINTMENT PROCESS WOULD LIKELY INCREASE BENEFICIARY SATISFACTION

Since the inception of TRICARE, beneficiaries have complained about the difficulties they encounter in making appointments for health care. For years beneficiaries seeking to make appointments in military treatment facilities accessed care by calling the desired clinic directly. Over the past several years however, DOD has been moving toward a centralized appointment system. In some military medical facilities an appointment center has been created and beneficiaries call that center to schedule various types of appointments. In four TRICARE regions though, TRICARE contractors have established regional appointment centers which beneficiaries call to schedule appointments with physicians in military medical facilities. The contractors perform this function as part of their administrative tasks under their contracts with DOD. We are currently reviewing the appointment making process in TRICARE.

We are finding that the lack of uniform appointment names and requirements for scheduling appointments has resulted in confusion for both appointment clerks and beneficiaries, with beneficiaries sometimes being transferred from the appointment center to the military clinic, or told to call the clinic themselves.

Thus, what is meant to be a simplified, more user-friendly appointment process appears to be a complex and confusing process, where beneficiaries are unsure as to whether to call the contractor or the military medical facility to schedule appointments. We expect to be making recommendations at the conclusion of our work.

Mr. Chairman, this concludes my prepared statement. I will be happy to answer questions you or other Task Force members may have.

Mr. THORNBERRY. Mr. Meyer, we will go ahead and let you proceed with your opening statement. We do have a vote, so members may be coming and going. I think it is just one vote, so we will try to keep things going as best we can. You may proceed.

STATEMENT OF WILLIAM J. MEYER, SENIOR VICE PRESIDENT OF TRICARE, BLUE CROSS-BLUE SHIELD OF SOUTH CAROLINA

Mr. MEYER. Thank you, Mr. Chairman, Congressman Shays, Congressman Moran, Congressman Thornberry, Congressman Spratt, Congressman Buyer. I thank you for the opportunity of inviting me here today and thank you for your interest in the experience of my company, Palmetto Government Benefit Administrators, a division of Blue Cross-Blue Shield of South Carolina.

I appreciate your concern with the difference in processing costs between Medicare and TRICARE and welcome the opportunity to give you some information and ideas based on our experience. Blue Cross-Blue Shield of South Carolina, through its subsidiaries, is the largest claims processor in the country for both Medicare and TRICARE, so we have a thorough understanding of the administrative cost structures and program differences of both programs.

The national average cost to process a Medicare claim in fiscal year 1999 was \$1.78. The average cost to process a TRICARE claim at my company is just over \$7.50. While on its face this is a large disparity, close analysis shows that there are reasons for it. The best way to understand the differences in these processing costs is to understand the differences between the two programs.

The most important difference is the most basic. By definition, Medicare is a fee-for-service program while TRICARE is a managed care program. The whole concept of managed care is that managing health care to maximize its efficiency will result in increased administrative cost, but that resulting efficiency will save far more than its cost. A complex system of authorizations, referrals, and discounted provider networks means that the same service might get paid for in dozens and even scores of different ways. This acknowledged administrative complexity is far different from what we find in Medicare, where fees are set, regardless of the provider, and almost every claim is paid the same way.

There is a propensity to look at claims processing costs without accounting for savings on the benefits side, but an accurate analysis of the cost of Medicare and TRICARE demands that you look at both. As an example, one reason processing TRICARE claims is more complex, thus more costly, is that physicians in the program are paid different amounts for the same procedures. That is because reimbursement rates are negotiated to get the most savings possible. You would save on processing if you make all the reimbursement rates the same, but you would lose whatever you are now saving by negotiating rates with providers. It is my strong belief that for many, if not most, of TRICARE's administrative costs, you will find a substantial savings on the benefit side.

Another issue contributing to TRICARE's higher processing cost is the wide range of coverages available under the three-tiered managed care benefit. While Medicare has one benefit package standardized nationwide, TRICARE beneficiaries choose from among the standard indemnity plan, a point-of-service network provider option, and an HMO-like option. Additionally, each prime contractor can offer its own unique menu of coverages in addition to the standard benefit.

There are also, of course, enrolled and unenrolled beneficiaries with a seemingly infinite number of possible combinations of cost and benefits. These choices and options and the constantly evolving benefits make TRICARE more attractive to the user, but much more complicated to administer. Processing these claims accurately in a timely manner is much more labor intensive than processing the standard claims for Medicare benefits.

This complexity also results in a tremendous number of inquiries from both beneficiaries and providers, primarily related to benefits, cost share, and claim payments. Inquiry rates are four times higher for TRICARE than for Medicare. In fact, we receive one inquiry for every 4.5 TRICARE claims. We are required to provide toll free numbers for these inquiries, which certainly seems to be a service that these beneficiaries deserve, but it adds significantly to the cost of processing claims. And while HCFA requires Medicare providers to use the contractor's automated response telephone system when checking on the status of claims less than 30 days old, there are no such restrictions on TRICARE providers.

Another difference between Medicare and TRICARE is size. The cost difference here derives from the principle of economy of scale, with which I know you are familiar. Each program has certain fixed costs, including software development and maintenance costs, fraud and abuse detection, and EMC marketing costs. Medicare's

fixed costs are spread over nearly 900 million claims a year, about 30 times the number of TRICARE claims. The huge volume of Medicare claims reduces unit cost. For example, \$10 million in fixed costs to Medicare translates to just over one penny per claim compared to more than 39 cents per claim for TRICARE.

A major factor in claims costs is the use or lack of use of electronic media claims filing. The cost of handling paper claims is \$2 or more higher than the cost of processing them electronically. Our Medicare division receives 85.5 percent of its medical and surgical claims electronically. We receive less than 20 percent of TRICARE medical and surgical claims electronically. If we could achieve the same 85.5 percent electronic rate, we would reduce our costs by 26 percent.

There are multiple reasons for this disparity in electronic filing. The biggest reason is that TRICARE rarely represents more than 5 percent of a provider's income, while Medicare typically represents 35 to 60 percent of his or her income.

Adding to this financial leverage Medicare has on a provider, HCFA has mandated that all paper claim submissions be held and not released until they are 27 days old. Compare that to TRICARE. Fifty percent of TRICARE providers submit ten or fewer claims per month. Ninety-eight percent of those claims are paid within 30 days, averaging 12 to 14 days. There is simply no financial reason for a provider to go through the additional hassle and expense of an electronic system for TRICARE.

Much of what I have said today has stressed the differences between these two programs. It is difficult to compare with an eye toward reducing the claims processing cost of two programs whose concepts are completely different. I would like to suggest to you that you might want to compare TRICARE with the Federal Employees Health Benefits Program, FEHBP, which, as you know, is quite highly regarded in terms of both benefits and administration and which is much more like TRICARE than is the Medicare program. Both are managed care programs, while Medicare is a fee-for-service program. My research shows that FEHBP and TRICARE have almost identical costs for claims processing.

Since we are comparing administrative costs for TRICARE with those of Medicare, however, let me quickly add that the General Accounting Office recently raised questions about the low administrative cost for Medicare. When cost is measured against future population growth in the Medicare age brackets, coupled with medical technology advancements and consideration of new mandates, William J. Scanlon, Director of Public Health Issues of the Health, Education, and Human Services Division of the GAO, testified before the Senate's Committee on Finance on May 4, 2000. Here is part of what he said, and I quote. "Contractor budgets for claims administration have been falling in proportion to the volume of claims they process. Relative to the size of private health insurers and their administrative budgets, HCFA runs Medicare on a shoestring."

Blue Cross and Blue Shield of South Carolina is eager to work with you on finding ways to reduce claims processing costs, and indeed, we are always working toward streamlining and improving

our processes. I appreciate your interest in my testimony and I will be happy to answer any questions.

Mr. SHAYS [presiding]. Thank you, Mr. Meyer.

[The prepared statement of William J. Meyer follows:]

PREPARED STATEMENT OF WILLIAM J. MEYER, SENIOR VICE PRESIDENT OF TRICARE,
BLUE CROSS-BLUE SHIELD OF SOUTH CAROLINA

Congressman Shays, Congressman Moran, Congressman Thornberry, thank you for inviting me here today, and thank you for your interest in the experience of my company, Palmetto Government Benefits Administrators, a division of Blue Cross Blue Shield of South Carolina. I appreciate your concern with the difference in processing costs between Medicare and TRICARE, and welcome the opportunity to give you some information and ideas based on our experience. Blue Cross and Blue Shield of South Carolina, through its subsidiaries, is the largest claims processor in the country for both Medicare and TRICARE, so we have a thorough understanding of the administrative cost structures and program differences of both programs.

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There is a propensity to look at claims processing costs without accounting for savings on the benefit side, but an accurate analysis of the costs of Medicare and TRICARE demands that you look at both. As an example, one reason processing TRICARE claims is more complex—thus more costly—is that physicians in the program are paid different amounts for the same procedures. That is because reimbursement rates are negotiated to get the most saving possible. You could save on processing if you make all the reimbursement rates the same—but you would lose whatever you now save by negotiating rates with providers. It is my strong belief that for many, if not most, of TRICARE's administrative costs you will find a substantial saving on the benefit side.

Another issue contributing to TRICARE's higher processing costs is the wide range of coverages available under the three-tiered managed care benefit. While Medicare has one benefit package, standardized nationwide, TRICARE beneficiaries choose from among the standard indemnity plan, a point-of service network provider option, and an HMO-like option. Additionally, each prime contractor can offer its own unique menu of coverages in addition to the standard benefit. There are also, of course, enrolled and unenrolled beneficiaries, with a seemingly infinite number of possible combinations of costs and benefits. These choices and options, and the constantly evolving benefits, make TRICARE more attractive to the user, but much more complicated to administer. Processing these claims accurately in a timely manner is much more labor-intensive than processing the standard claims for Medicare benefits.

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number of TRICARE claims. The huge volume of Medicare claims reduces unit costs. For example, 10 million dollars in fixed cost to Medicare translates to just over one cent per claim, compared to more than 39 cents per claim for TRICARE.

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Since we are comparing administrative costs for TRICARE with those for Medicare, however, let me quickly add that the General Accounting Office recently raised questions about the low administrative costs for Medicare, when cost is measured against future population growth in the Medicare age brackets, coupled with medical technology advancements and consideration of new mandates. William J. Scanlon, Director of Health Financing and Public Health Issues of the Health, Education, and Human Services Division of the GAO, testified before the Senate's Committee on Finance on May 4, 2000. Here is part of what he said, and I quote: " * * * contractor budgets for claims administration have been falling in proportion to the volume of claims they process. Relative to the size of private health insurers and their administrative budgets, HCFA runs Medicare on a shoestring."

Blue Cross Blue Shield of South Carolina is eager to work with you on finding ways to reduce claims processing costs, and indeed, we are always working toward streamlining and improving our processes. I appreciate your interest in my testimony, and will be glad to answer any questions.

Mr. SHAYS. Other members are voting and they will be back to ask questions. My name is Chris Shays. I chair this committee along with Mr. Thornberry and I also chair the National Security Subcommittee that oversees all of DOD for all programs, including health care. While my Subcommittee on Government Reform has not really gotten into health care, we did get into health care issues when I chaired the Human Resource Subcommittee and it is an issue we are tremendously interested in.

Dr. SEARS, I would like to have you just kind of describe to me your perception as you would be listening to veterans of all the reasons why they do not find TRICARE as satisfactory as you would like or as I would like.

Dr. SEARS. When you say veterans, sir, do you mean—

Mr. SHAYS. I do not mean veterans, I mean our military personnel.

Dr. SEARS. Yes. I think—

Mr. SHAYS. I might say also that my subcommittee also oversees veterans' affairs and we have focused time on veterans' affairs, so I let it slip there.

Dr. SEARS. I was afraid you were getting out of my area—

Mr. SHAYS. That is also my bias, that I eventually would like to combine both health care systems, too, so that is another issue.

Dr. SEARS [continuing]. Although many of our beneficiaries are veterans, obviously. As we track satisfaction, which, incidentally, has shown a trend of steady improvement since the beginning of TRICARE in each of the regions in studies and surveys done by outside consultants, clearly, the remaining challenge, the largest remaining challenge to us is the issue of access, and that revolves around the difficulties with telephone access, sometimes a problem of infrastructure in our military treatment facilities, particularly, and sometimes a problem with access to easy appointments and sometimes access to particularly acute care appointments.

We have made tremendous progress in those areas, but as Mr. Backhus pointed out, this is an area they are studying. It is an area where we have done a lot of work and there are significant improvements in place and many that are going in place over the next few months. But we must solve the telephone access problem, moving toward the utilization of one TRICARE number nationally that downlinks, and looking at other issues.

The biggest problem we face—

Mr. SHAYS. You say one number. There is not one 800 number nationwide?

Dr. SEARS. No, there is not. There is an 800 number regionally—

Mr. SHAYS. See, I would have trouble understanding that. I mean, given that our military fly everywhere and go everywhere, why would that not have happened yesterday?

Dr. SEARS. We are talking about a number to access claims, and currently, the way the contracts are set, we have different contractors in different regions who manage that central phone, so that you access it currently on a regional basis because you are enrolled in a particular region, so you get served by that region.

Mr. SHAYS. But they all have their own number. I use my Visa card and I enrolled in one place but I can go anywhere in the world and I can use it.

Dr. SEARS. Yes, sir, and that is where we are moving as rapidly as we can. The banking card issue, or the USAA, which is what our members talk to us about, is exactly where we are moving. That will allow us, when we put that in place, and that is in the works, to have one number that downlinks to all of our regions for both advice and appointments and other information, as needed.

Mr. SHAYS. If I said to my staff they are going to do something as rapidly as possible, I would like to know, what does that mean, and they have trained me to ask the same thing. What does as rapidly as possible mean?

Dr. SEARS. Well, we are in the process, first of all, of—we have an IPT, a team that is working on this issue. They have now worked with a number of the folks who provide these sorts of services and they are looking to the establishment of a 1-800 number capability sometime next fall.

Mr. SHAYS. Not this fall?

Dr. SEARS. No, not this fall, next fall.

Mr. SHAYS. That does not seem as rapidly as possible, then. That seems like on our own good time. You raised telephone access as

a great aggravant—I did not, you did—and it would strike me that if that is the biggest problem, it is one of the easier parts of the problem to solve.

Dr. SEARS. There are several approaches to that, sir. One is through an improvement in our regional systems so that people can access that, and those initiatives, some of them are in place, some of them are going into place. But the larger problem of getting a downlink system that has the infrastructure and takes advantage of all the current technology is a longer process. We are striving to get that in place, obviously, as quickly as we can. We also have current contractual relationships in terms of some of those numbers that have to be modified. Contracts have to be modified to put that in place.

Mr. SHAYS. Well, it just strikes me, and I would think the other members of the committee, that doing it in a year and 3 months or so is not rapidly as possible.

What would be others besides telephone access? When I go out and I am listening to our men and women, they do not just tell me telephone access.

Dr. SEARS. No. The other major problem that we have had and are in the process of solving in very short order, this fall, is the issue of standardized appointments across our system. Right now, with the three military services doing appointing in different ways, using different appointment types, different templates, using different business rules for their appointing, we really have had a hodge-podge of different ways to get appointments.

We are putting in place now a standardized appointment system which reduces the number of appointment types from literally thousands in the past to a manageable number of eight or ten and building the templates that allow visibility of appointments to the folks who are doing the scheduling. If the appointing system is not properly structured, then even though you may have appointments available, they may not be obvious to the people who are making the appointments. That will be solved this fall.

We also have put out a software package that allows each of our military facilities to determine how they are utilizing their templates. It is called the template analysis tool. It allows them to make corrections in the way they are setting up their appointments so that they can correct their problems and make sure that the appointment availability is fully utilized. So those are very dramatic changes which will improve that access.

Now, as you know, under TRICARE, unlike CHAMPUS and our military health system before, we are guaranteeing our beneficiaries certain access availability. If you have an acute illness and need to be seen immediately, the guarantee is that you will be seen the same day. For routine appointments, we are guaranteeing a 7-day appointment standard. And for wellness visits and other consultations, up to 30 days.

For the most part, we are generally meeting those standards, and in the TRICARE system, if those standards cannot be met within the direct care system, within the military system, our requirement is that they be referred into the network so that they can be seen in a timely way.

Mr. SHAYS. Let me just, before, Mr. Chairman, yielding back, just be clear on one thing. Our military personnel are sometimes called at a moment's notice. Is there the flexibility to meet a change in their schedule quickly, because they may all of a sudden find they are going to be out to sea for a few days?

Dr. SEARS. Absolutely. Active duty folks have the highest priority, and certainly deploying units would have the highest priority for attention to their medical needs as they prepare for deployment.

Mr. SHAYS. Thank you very much. Thank you, Mr. Chairman.

Mr. THORNBERRY [presiding]. Mr. Spratt.

Mr. SPRATT. I will waive any questions.

Mr. THORNBERRY. Let me ask, I guess, kind of a bottom-line question. We hear that the average cost to process a Medicare claim is \$1.78. We hear that the average cost for the health insurance industry, I guess the private sector, is \$3.50 to \$4, ballpark maybe. And for TRICARE, it is nearly \$8. You all have given a variety of factors that causes TRICARE to be higher. Some of those, I suppose, are factors we can fix and some of them are factors we cannot fix.

What I would like to get a sense of is, what do you think the goal ought to be? Are we doing as well as we can do? Is \$8 or whatever it is as good as we can do, given the way that TRICARE is set up, or can we do better with electronic filing and other kinds of improvements? What should our goal be if things were running pretty well? Mr. Backhus, let me ask you to start.

Mr. BACKHUS. We asked ourselves and two claims processors that question, as well as the organizations that they process claims for, the TRICARE support contractors. We have analyzed the costs currently incurred in TRICARE. We have not looked at FEHBP at this point, but have a little bit of information on that.

It seems to me that the consensus around this is in the neighborhood of \$3 or \$4 per claim, which would be more like the industry average. There is \$3 or so in costs per claim that are above and beyond the real cost of determining payment. Some of these costs like maintenance of information relative to who is using the system and to detect and deter fraud and abuse, are necessary expenditures.

But there are so many different edits in the program that probably are not necessary, and there is so much opportunity with technology such as potentially using the Internet and other more state-of-the-art systems, that I think we are talking, in my judgment, about \$3 to \$4 per claim.

Mr. THORNBERRY. Mr. Meyer, do you agree that we can save that much money if we get everything running right?

Mr. MEYER. I think if we did everything possible, this program would cost at least \$5 a claim because of some of the basic inherent differences, and if you will just give me one moment, I will give you the best example I can, and that is our largest volume provider, we have five of the seven regions. We process 82 percent of the TRICARE claims.

The largest single provider we have across all five regions that does not submit claims electronically is the provider from the East Coast of North Carolina, a large group provider. They submit over

3,300 TRICARE claims per month, every month. They submit them all paper. We have been fighting to get these people to submit electronically.

Their answer to us is that they give TRICARE—they are a TRICARE Prime provider. They give TRICARE a 15 percent discount off the TRICARE rate for all their services. They are taking a 15 percent hit on the benefit dollars. Their electronic submitter is a company that charges them 35 cents a claim to submit claims electronically. Their paper TRICARE claims are getting paid in an average of 2 weeks.

They said there is exactly no reason for them to ever submit those claims electronically to us because they will be damned if they are going to give us—even though that 35 cents does not go to us, that is another 35 cents they would have to cut and they do not need the money in less than 2 weeks.

And that is the story over and over again. Once again, we could cut our costs 26 percent if we could get the same electronic rates as Medicare, and to say our electronic rate is 50 percent is a little bit misleading because most of that is pharmacy claims. Almost all of our pharmacy claims come electronically, but the hard claims, the professional claims and the surgical claims, only 17 to 20 percent of those come electronically.

Mr. THORNBERRY. I want to clarify that and get back to it in just a second, because I had that as a question, to resolve that difference.

But Dr. SEARS, what do you think? What ought to be our goal here that we could achieve if we get everything running right?

Dr. SEARS. I think Mr. Meyer has hit it pretty closely. Obviously, we want to get the cost as low as possible, but I think the \$2 to \$3 range is achievable.

Mr. THORNBERRY. So we could save \$2 to \$3 per claim if we get everything going right?

Dr. SEARS. I think that is achievable with HIPAA, when HIPAA gets into place, when we complete all of our restructuring of edits and reviews and all of the simplification things that we are going through right now in our task forces that are looking at how to prevent rework of claims. I think further savings are achievable and should be striven for. The new technology, obviously, will also help significantly and it is in some ways hard to predict what cost savings can be achieved through the new technology.

Mr. THORNBERRY. Do you agree with Mr. Meyer's point that if you just look at, set pharmacy aside and the rest of the claims, only 17 to 20 percent are filed electronically now?

Dr. SEARS. That is correct.

Mr. THORNBERRY. And you, I think, said something about 50 percent, but that is only when you include all the pharmacy?

Dr. SEARS. That is right.

Mr. THORNBERRY. OK.

Dr. SEARS. That is correct.

Mr. THORNBERRY. Now, it is a little puzzling to me why it takes so long and seems to be so difficult to get electronic filing done, because, as you mentioned, Congress passed a law several years ago to require everybody to move in that direction, and you all seem to be saying we have no tools at our disposal to get these providers

to file electronically. Are we making electronic filing too difficult for them? Do we have such a separate system for TRICARE with unique fields to be filled in and such special requirements for our computers that it is too difficult?

Dr. SEARS. Mr. Meyer is the expert in this, but if I am a physician practicing and I see a Medicare patient or a TRICARE patient, we use the same forms, the HCFA-1500 for individual providers and the UV-92 for hospital providers, the same form obviously for TRICARE and for Medicare. We have built things into the system now that mean that those claims could be submitted and processed—the same claim that could be submitted to the HCFA claims processor can be submitted to Mr. Meyer's organization and be processed.

Mr. THORNBERRY. OK. Mr. Meyer, if you are using the same form that you get anyway from Medicare providers, why can you not just use the same form and why can these doctors and providers not use the same form and e-mail it to somebody else other than—

Mr. MEYER. The form is the same, Mr. Chairman, but the data on the form is not necessarily the same, the data required on the form. There are some additional things that have to be put on that form for a TRICARE claim that does not have to be put on that form for a Medicare claim.

Mr. THORNBERRY. Are there some of those things we can get rid of?

Mr. MEYER. No, not really. You need to know branch of service, you need to know—there are TRICARE particulars you have to have. But let me say that that is not a large impediment. For the most part, that is a one-time cost, to modify a system to accept it for TRICARE.

The bigger impediment is, once again, more than 90 percent of the TRICARE claims we receive, excluding drug ones again, are coming from providers that submit less than ten claims per month. In other words, they are submitting 800 Medicare claims, three TRICARE claims. They say, we are not going to go through the expense of adjusting our automated system. It is going to cost us \$400 to fix our automated system to accept TRICARE claims for three or four claims a month when you are paying them in less than 30 days anyway. There is no advantage for us to do that. We run into that over and over and over again.

Mr. THORNBERRY. I am sure it is just my ignorance. I am just not quite understanding why it should be so much more difficult, if you are already submitting so many Medicare claims, to submit a TRICARE claim on the same form.

Let me ask one last question and then see if my colleagues have questions. Mr. Backhus, you used the example of these electrocardiograms. Would you explain that to me? As I understand it, from one provider alone, 14,000 claims for electrocardiograms were all sent over here for manual review. Now, I presume that means somebody looking at each piece of paper and approving each of those claims manually, when none of them are ever denied. Can you explain that to me?

Mr. BACKHUS. I will try. The history of this dates back to program requirements that preceded TRICARE. At a time when CHAMPUS was in place and the Department of Defense was, in

fact, a direct payer of claims, there was a feeling that there was a need to screen claims for many different kinds of services, in other words require that claims for many different services be edited and reviewed for medical necessity. In this particular case, the requirement was for all electrocardiograms claims to be manually reviewed for that purpose.

Now that TRICARE is here and the contractors have some fiscal responsibility for the costs, the responsibilities for determining medical necessity and appropriateness rests in many cases with them. However, technologies have changed and utilization has changed, and thus, in some cases, the need to review services in particular have changed.

Electrocardiogram claims fall into that category, but the requirement did not change. It is outdated, probably needs to be—in fact, recently, a policy has been put into place, as I understand it, to permit the contractors now to remove that particular edit from the claims processing system. It is not in place at this point, but it should be within a few months.

The other thing I would like to clarify is that the 14,000 claims are from one particular TRICARE contract, one particular region.

Mr. THORNBERRY. We do not want to make too much out of each individual instance, but I think it is helpful for us to get a feel for some of the problems that we are trying to sort through and why these costs are so much, because obviously if you have got to go through 14,000 pieces of paper, each one and every one gets approved, then that is an unnecessary expense in a variety of ways and it is one example.

Mr. SPRATT. Would the gentleman yield?

Mr. THORNBERRY. I would be happy to yield to the gentleman.

Mr. SPRATT. With respect to your cost, I am not quite clear as to your testimony. You testified, Mr. Meyer, that in addition to just the direct cost of processing a claim, you are also handling the network, responding to provider inquiries, responding to patient inquiries, and trying to make this managed care network an efficient provider as opposed to just some fee-for-service situation where you pay whatever the charge says to pay.

Are you saying that when you give us your per claim estimate of what it costs to settle one claim, pay one claim, you are dividing the number of claims into the total compensation you receive from managing this whole program?

Mr. MEYER. That is correct, Congressman. Typically, claims processing costs in this program includes all the things you just mentioned, includes providing the telephone service, the toll-free lines, the responding to written inquiries, the management of the provider file and pricing files. It is all rolled together. The cost to actually process the claim with none of that itself is \$2 and some odd cents.

Mr. SPRATT. So it is pretty close to Medicare, the actual claims management aspect.

Mr. MEYER. Right. But in fairness, Medicare includes the cost of processing the inquiries and they are \$1.78. So the \$1.78 for Medicare and the \$7.50 for TRICARE is as close as you can get to apples to apples for the different requirements.

Mr. SPRATT. But does the \$7.50 include all of these other managerial responsibilities?

Mr. MEYER. Yes, it does, and many of those, Medicare does not have. Medicare does not have to manage the one million provider file that I have to manage. It is very, very small compared to that.

Mr. SPRATT. To what extent do you have to nourish the network? Do you have to deal with providers and try to coax and persuade them to stay in the network? I know in South Carolina, which is under your purview, we have had a problem with the TRICARE network, first of all building it up and filling out different aspects of it, and then keeping some of those who signed up originally in the system.

Mr. MEYER. Yes, we do that, Congressman. We have a very—it is probably 60 cents a claim that we spend on just maintaining those provider networks. It is classic, for example, for one doctor to belong to one group and be in the network in that group and belong to another group at the same time and not be in the network in that group, which is legal but not ethical. He can manage his fees that way. In other words, as a part of the network in this group, he is going to get paid \$50 for a service, but in this other group, he can get paid \$75 for the same service, so he will move over to that group to get that service done. We have to manage that. There are over one million individual providers on our provider file that we have to manage the pricing on those things and the complexity is just enormous, and that is 60 cents a claim that Medicare does not experience.

Mr. SPRATT. I thank the gentleman for yielding.

Mr. THORNBERRY. I thank the gentleman.

Mr. Buyer.

Mr. BUYER. Thank you, Mr. Chairman. Back to the hearing that we had this past spring, of all the hearings that I have ever attended or chaired in Congress, as I look back at that one, it was 5 hours. It was a marathon hearing that we had, but it was also one of the most productive I think that I have ever participated in because we talked about TRICARE. No one could duck anything. They were all in the room. I was going through the white paper that one of the companies had submitted and I wanted to touch on a couple of things.

If we were to, back to the chairman's initial questions of you, to get at it quickly, when you talk about—I would appreciate your testimony about what are the front costs and then discuss the inquiry rates and why is there such a differential in the inquiry rates between Medicare and TRICARE, and those are two huge cost drivers.

Mr. MEYER. Absolutely. Let me take the inquiry rates first. We have, once again, we get more than five million telephone inquiries per year for our claim volume, one phone call for every four-and-a-half claims. One of the reasons why that is so different compared to Medicare, and it is an important point to make, is that our research has shown that 50 percent of our phone calls are people, mostly providers, calling to find out the status of the claim. Sixty percent of that 50 percent are phone calls on claims less than 30 days old.

In Medicare, those phone calls must go through the automated voice response unit. In other words, a doctor cannot opt past the automated response unit to a human attendant. In TRICARE, there is no such prohibition. Virtually 100 percent of them go right past the automated response unit and come to an individual to answer. This usually inflates the volume of phone calls. I would go on a limb to say 30 percent of our phone calls could be eliminated if we required, as Medicare does, those providers to use the automated response unit for claims that are less than 30 days old.

Once again, more than half the phone calls we get on claim status are claims for 8 days old, 10 days old, 12 days old. It is routine. We have the same providers call every Monday and they call on the list of every claim they have submitted. Even if the claim was submitted last Thursday, they are calling for the status on a Monday. They read off 50 claims and they want the same status.

Mr. BUYER. What had been submitted to me was that—and I wish you would concur or not concur—that with regard to Medicare, you receive one inquiry per 18 Medicare claims.

Mr. MEYER. That is correct.

Mr. BUYER. TRICARE, it is one inquiry for 4.5 claims.

Mr. MEYER. That is correct. That is the ratio.

Mr. BUYER. That is almost five times the amount.

Mr. MEYER. It is exactly four-to-one, right.

Mr. BUYER. That is stunning, especially given the volume of Medicare claims you process versus TRICARE claims. So this issue of moving toward greater simplification—

Mr. MEYER. It is a huge benefit.

Mr. BUYER [continuing]. It is a huge benefit. Will you share with the committee a breakout of what you meant by front costs? If the front end costs were—front end costs are handled different ways.

Mr. MEYER. Right.

Mr. BUYER. Break that out. Define that for me.

Mr. MEYER. That is the mailroom, the place that receives the 25 million claims that we receive. That is the cost for coding all those claims and data rendering all those claims into the system. That is the cost of passing the paper around, collecting the paper, and then, in fact, sending the paper off to storage places for that paper to be stored, because, frankly, the Federal records centers are all full so we have to absorb the cost of retaining 25 million claims and associated correspondence per year.

Mr. BUYER. So you threw in mailroom, document preparation, imaging, distribution, data entry, paper storage, according to this white paper by your company, it could add up to \$1.35 to \$1.50 per claim.

Mr. MEYER. Right, Congressman. Since we did that paper, we looked at it closer and it is actually closer to \$2 per claim.

Mr. BUYER. That is almost equivalent to the cost of Medicare alone, and that is just the front cost.

Mr. MEYER. That is correct.

Mr. BUYER. That is pretty stunning when you think about that.

Mr. SPRATT. Would the gentleman yield?

Mr. BUYER. Yes.

Mr. SPRATT. Is some of this due to the fact that this is a new program, you are just getting accustomed to it, getting your provid-

ers in the groove, so to speak, and they therefore have more inquiries, they need more guidance?

Mr. MEYER. The inquiries in this program—well, yes and no. For example, we get more inquiries on the newer contracts than we get on the more mature contracts. For example, we process claims for Regions 9, 10, and 12, which is the States of California and Hawaii and Alaska. The ratio of calls to claims there is lower than the ratio of calls to claims, for example, in the Mid-Atlantic region, which is one of the last regions to come up, where people are still getting used to the complexities of the TRICARE program and still do not understand what the benefit is and what the cost share is all the complexities associated with the program.

Mr. SPRATT. If you had electronic filing, do you avoid most of this front-end cost?

Mr. MEYER. If you have electronic filing, you avoid all of the front-end cost.

Mr. SPRATT. Gee whiz. Do we give providers the software, or do they have to buy proprietary software?

Mr. MEYER. We have a free product that we offer every single provider. We say, this is absolutely free to you, this software. As a rule, once again, they are already using another software package and they are using it primarily for Medicare or they are a large commercial carrier and they say they do not want to run two packages, even though it is free. They have a large vendor that does this for them and they do not want to run the second package, and thanks but no thanks.

If there was a way to do it, we would eliminate that paper tomorrow. It would drop right down to our bottom line. There is no reason not to do it.

Mr. SPRATT. If the gentleman would yield still, does the software we provide free integrate easily with most operating systems?

Mr. MEYER. Yes, it does. It is on a floppy disk. You pop it into your computer and away you go. We will have the capability within 1 to 2 months for anybody, any provider in the country to submit TRICARE claims across the web. All you need at that point is government permission to get past whatever security issues that they have. We believe we have that conquered and then 100 percent of all providers in the country can file electronically across the web free.

But my prediction is they are still not going to do it, because once again there, they have three large systems in place that they are submitting from Medicare, which is 50 percent of their income, and they are going to say, that is what I am using and that is all I am going to use. We may pick up some around the edges in the three or four claim per month providers that say, well, we can get them done this way.

Mr. SPRATT. Do most of these providers also have a separate software package for Medicaid in their particular State?

Mr. MEYER. I could not answer that question for Medicaid. I can look it up for you. For Medicare, I know, but not for Medicaid. I would not know.

Mr. SPRATT. Blue Cross-Blue Shield, do you provide your PPOs and others who are approved providers, do you provide them with software for submission of electronic claims?

Mr. MEYER. Yes, we do.

Mr. SPRATT. And is the acceptability rate there high?

Mr. MEYER. Yes, it is, and once again the reason is the financial leverage on the doctors we have in the State of South Carolina. For the most part, we represent anywhere from 33 percent to 80 percent of their income.

Mr. SPRATT. Again, it is market share.

Mr. MEYER. Right.

Mr. BUYER. We were very cautious when we did the defense bill not to place the mandate to electronic filing. We have Dr. Sears here and Mr. Backhus. Let us explore that for just a moment.

Mr. Backhus, on page 7 of your written testimony, you indicate that one of the challenges in reducing the cost of TRICARE claims processing is increasing the number of providers who are submitting claims electronically. You indicate that this is not likely to happen without either incentives or mandates. I agree with your assessment that mandates might actually drive providers away from TRICARE.

What kind of incentives can be used to encourage providers to make more use of electronic means of filing claims, to make sure that that does not happen? I mean, how do we work cooperatively here, DOD with contractors and providers, to make sure that does not happen rather than Congress coming in and saying, you cannot get it right. We are just going to mandate and we are going to micromanage.

Mr. BACKHUS. First of all, if these HIPAA requirements do come to pass and data submissions are similar for every program, then that would go a long way toward providing incentives for people to do this that would not require their own separate systems and software packages.

Secondly, you know, Medicare, as Mr. Meyer pointed out, has tried to provide incentives for electronic claims processing by permitting, or actually requiring, that the paper claims not be paid in less than 26 days, whereas electronic claims, of course, can be processed and paid much quicker. The same possibility exists here to do this. He says his company processes the paper claims in 2 weeks.

Mr. MEYER. On average.

Mr. BACKHUS. On average, and the standard is 30 days. It may not be popular, but it is possible that if paper claims were paid something closer to 30 days, it may offer these folks an incentive to submit electronic claims because they will get paid quicker. Now, as he says, if they are going to get paid in 2 weeks with the paper claim, what reason do they have to change?

There is another opportunity here that I think exists that is more technical in nature and Mr. Meyer can probably explain it better than I can, but, for example, there are opportunities for TRICARE to try to adopt the Medicare provider identification numbers. What this means simply is that when a TRICARE provider wants to file a claim, their unique identification number does not fit into the current TRICARE electronic formatting and contractors have to convert their systems to try to adapt if they want to file under TRICARE.

There is a possibility to go ahead and allow these folks just to use their Medicare numbers, for the TRICARE system to recognize that, convert it over to whatever the particular network is that this TRICARE provider is associated with, and process the claim that way.

Mr. BUYER. Mr. Chairman, may I be permitted a little latitude? Dr. Sears, would you please comment on what we have just heard from these two other gentlemen's testimony—

Dr. SEARS. Sure.

Mr. BUYER [continuing]. Because you have some kind of responsibility here.

Dr. SEARS. Yes, sir. What you are hearing described is a delicate balance that we have, in part, in attracting providers and keeping providers in the network, and the service that is provided to the provider is very important both in terms of the ability to access information about inquiries and the ability to get paid in a timely way. And so often, we hear from provider groups that they are willing to stay, they do not like the reimbursement, but they are willing to stay because they are getting paid in a timely way and there is a customer service feature that has been helpful to them. So I think you can see the tension there between mandating, which, as has been pointed out, could drive people out of the system and the other approach.

Again, Mr. Meyer is the expert here, but the government has given approval to the contractors to use the UPIN, the Universal Provider Identification Number, and we used to require that, I believe, the tax ID number and a sub-identifier, but there is now an ability to crosswalk between the UPIN number and the tax ID number, so that should not be an issue.

Mr. SPRATT. Will the gentleman yield?

Mr. BUYER. Yes.

Mr. SPRATT. Mr. Meyer, Mr. Backhus mentioned HIPAA and standardization, and I understand that your particular company has a problem with standardization. According to your experience, it turned out to be much more complex than it would seem and it is also going to be very costly. Would you care to comment on that?

Mr. MEYER. Well, I think you just said it, Congressman Spratt, that our experience in our company is we do not—it is not that we disagree with HIPAA. We just feel that by the time the smoke clears on HIPAA, the cost for administration, for the implementation of HIPAA will probably be four times higher than what is currently being said. We think there is a huge cost to doing it and it is going to drag out over a protracted period of time. I have very little confidence that it is going to be in 2 years like they say it is going to be. The way the committees on that are progressing, they are just not progressing at all.

Mr. BUYER. I want to switch gears for a second, because Dr. Sears, one item in your written testimony concerns me a great deal. You state the Department is evaluating contractor proposals to eliminate the TRICARE Encounter Data System as a replacement for the Health Care Service Record. The committee staff has worked closely with you and in the 2001 Defense Authorization Act, you specifically requested and we put in the bill \$3.1 million to finish the work on TEDS. So what is up here?

Dr. SEARS. We are studying, as the testimony says, but our intention is moving to replace the HCSR, the Health Care Service Record, with the TRICARE Encounter Data, again——

Mr. BUYER. You intend to finish the work on TEDS?

Dr. SEARS. We intend to implement that. We are always looking at ways to do business in a better way, and this has been a very strong demand from our contractors, to look at another way of doing this. So we are looking at that. We are working with them. But that has not impaired in any way our implementation or our switch from the HCSR to the TED.

Mr. BUYER. OK. You see, we want to be helpful here and be responsive and that is the challenge we have made not only to you but under the contractors, and so if you have asked us to fund a particular system while you are also looking, we want to make sure we are casting good judgment.

Dr. SEARS. You are and it is appreciated and we are proceeding, and we appreciate the language in the bill this year that supports that.

Mr. BUYER. Thank you, Mr. Chairman. I will have a second round of questions. I yield back to the chair.

Mr. THORNBERRY. Mr. Shays.

Mr. SHAYS. Thank you. I am still wrestling with something that is kind of silly, but I am still wrestling with it. If you are telling me the primary negative that your recipients have to health care is access and just finding a real live person or getting information, and you are telling me that you do not have a uniform number for people to call in this day and age, and then you are telling me they are going to do it as rapidly as possible and rapidly as possible means next September, not this September, I am just wrestling with the question mark as to why, if this is a serious problem, at least in terms of product satisfaction, it could not be done in a month or two.

Why can they not call an 800 number? Why can the 800 number not know exactly where it is coming from and refer to the, I guess you have 11 regions, is that correct?

Dr. SEARS. Twelve regions.

Mr. SHAYS. I mean, the average stay that a military person has in one area has got to be relatively small. So of all the organizations that should want to do this, I would think you would want to do it before almost any other organization. Mr. Meyer or Mr. Backhus, tell me why it would be a problem to do this sooner than 15 months from now. Why could it not be done sooner?

Mr. MEYER. Congressman, I think there are actually two issues on the telephone that Dr. Sears is talking about. One is the phone system where people call to get appointments.

Mr. SHAYS. Right.

Mr. MEYER. And the other is the phone system they call if they have claims questions. I think one phone number could handle it for the claims questions and another phone number—two phone numbers, one phone number for claims issues and another phone number for appointments and I think that could be done.

Mr. SHAYS. In the private sector fairly quickly, correct?

Mr. MEYER. I am sorry?

Mr. SHAYS. In the private sector, fairly quickly?

Mr. MEYER. Yes.

Mr. SHAYS. Mr. Backhus, you made some specific recommendations that would be helpful and one of them was dealing with the perennial and daily problem of fraud. What I was struck with was your pointing out there are 40 million claims processed from January 1999 through April of 2000. Only 17 fraud referral cases from the contractors have been accepted by DOD for investigation. That boggles my mind. I mean, that seems so tiny, and I would like you to just talk about it a bit.

Mr. BACKHUS. OK. A year ago, or about a year ago, we looked at this issue extensively. While recognizing TRICARE is a different program than Medicare, and the two are hard to compare, we were struck by how relatively little activity there was at the contractor level in terms of the referrals that they were making to other parts of the Department of Defense involving potential health care fraud. We asked why and how this could be, and what would one expect out of a program this size. We learned that while there are requirements in the contracts for the contractors to have programs in place to do certain kinds of analyses of claims, to look for patterns and trends and things like that, they were very poorly staffed.

Mr. SHAYS. And is the reason because they have no financial incentive?

Mr. BACKHUS. No.

Mr. SHAYS. In other words, it is not their money?

Mr. BACKHUS. No, they do have incentives. This is the odd thing about it. They do have, in many cases, the incentive to do this because they are at risk for the health care costs that are incurred. It just did not seem to be something that they had yet pursued with the vigor that ultimately they ought to.

Mr. SHAYS. Well, how much are they at risk and how much is the government at risk? What is their risk?

Mr. BACKHUS. That is a complicated thing. I am not so sure I can give an easy answer to that question.

Mr. SHAYS. Give me your best effort.

Mr. BACKHUS. Essentially, the contracts are fixed price. The simple explanation is that for the population that the contractors are serving, they bid a fixed price for those services. If the costs exceed what they have bid on and were awarded in the contract and those costs are not attributable to unforeseen circumstances, such as population shifts and things like that or inflation, unanticipated inflation, then they are at risk for a portion of those excess costs shared with the government.

I am having trouble. I would have to provide for the record what that split is, but I think Dr. Sears probably has—

Mr. SHAYS. Mr. Meyer, can you help me out here?

Mr. MEYER. It is 80/20, Congressman Shays.

Mr. SHAYS. So who has the 80?

Mr. MEYER. The government does.

Mr. SHAYS. And the contractor has 20? And we have a measly 17 cases out of 40 million?

Mr. MEYER. Congressman, once again, I am a little bit troubled by the numbers in that I know I have right now several thousand claims suspended for fraud investigation. So, you know, sometimes a case might involve 8,000 or 9,000 claims. I think you have got

a little bit of apples and oranges here again. We talked about 40 million claims and 17 cases. Those 17 cases can represent a whole lot more than one claim per case.

Mr. SHAYS. I understand that, but if only 17 organizations or people were prosecuted—is that what I understand to be right, Mr. Backhus?

Mr. BACKHUS. No, these are active cases.

Mr. SHAYS. That would not strike fear in the hearts of someone who is seeking to get payment, if 17 out of—but the cases are 40 million, so your point is that there are not 40 million vendors, obviously. But in our work with Medicare and when we recommended that we have health care fraud be both a Federal and State offense, that it would be both Federal as well as State so people could not go from one area to the other, I mean, we are capturing billions of dollars as the result of those changes.

I guess what I am interested in is, what would you recommend, Mr. Backhus, to beef up this effort? I mean, I am going to make an assumption that I do not have to be a rocket scientist to, that between fraud and abuse, we have got billions of dollars at play.

Dr. SEARS. If I could answer that, sir—

Mr. SHAYS. Yes.

Dr. SEARS. First of all, the 10 to 20 percent is really felt to be an inaccurate projection of what the fraud and abuse is. The National Health Care Anti-Fraud Association feels it is between 3 and 5. Now, I am not belittling the problem—

Mr. SHAYS. But between 3 and 5—

Dr. SEARS [continuing]. I am just saying the magnitude of it is not as great as it may have been portrayed. We have probably the leading industry piece in terms of pre-pay edits and edits in the system that detect abusive claims, many of which are potentially fraudulent claims. So those are identified in the system before the claim is paid, and with the prepaid edits, that amounts to about seven million in claims saving a year, and in the software that detects inappropriate or potentially abusive or fraudulent claims, we save about \$87 million a year in that area.

Mr. SHAYS. What is the total expenditure that we make, \$8 billion? Out of how much? I am trying to understand the overall billing.

Dr. SEARS. The total purchased care dollars that we expend is about \$2.9 billion for purchased care in our system. We have, in the last year and a half, instituted what is called the Operation TRICARE Fraud Watch, which is a very aggressive approach to address many of the issues that Mr. Backhus raises. We have required, are requiring—it is not totally in place yet but it is going into place—artificial intelligence software that we have mandated that each of our contractors use to further identify potential cases of fraud that then can be identified.

We make a major contribution through our national database, our TRICARE purchased care database, in support of HCFA, the FBI, the Defense criminal investigators—

Mr. SHAYS. I am just going to interrupt you and let others ask questions.

Dr. SEARS [continuing]. How to do that.

Mr. SHAYS. The bottom line is, there is 17 out of 40 million.

Dr. SEARS. Yes.

Mr. SHAYS. That is the bottom line, and the bottom line, that would suggest that there is not the aggressive effort.

Dr. SEARS. Yes. Now, that is not all the referrals that we get. Those are the referrals that we have gotten that we feel where there has been potential harm done to the patient or where there is significant recovery. There would be a number of other submittals to us that get returned to be investigated as abusive claims rather than fraudulent claims.

But frankly, that is—I do not want to be misunderstood here. We think that is a low number also, and it has become a special interest item during our quarterly meetings with our contractors where we review their turning over to us for potential fraud cases, and we expect that to increase. In fact, we are seeing increases, not as dramatic as we had hoped, but we are seeing increases this year in referrals and anticipate with the utilization of the additional software piece and all of the other educational efforts—we have required the contractors to put on the explanation of benefits forms a fraud hotline number. The EOB is one of the great detectors of fraud and we think that is an effective way. We have established a web page that also identifies sanctioned providers and gives people the direction and providers the direction in terms of how to report fraud.

Mr. SHAYS. Let me thank—

Mr. BUYER. Would the gentleman yield to me for a moment?

Mr. SHAYS. Sure.

Mr. BUYER. I have listened to this and I am not completely satisfied that, despite what you have testified to, Dr. Sears, is completely responsive to Mr. Shays. That is my personal observation.

What we have here is Mr. Backhus, with regard to his interest in the Department of Defense efforts to implement an effective system for identifying waste, fraud, and abuse, comes out and says, we have identified potential losses of up to \$580 million. Mr. Shays and the Budget Committee's reaction to that is appropriate. I think that is incredible. Then when you add to that and say that 17 cases of potential fraud were accepted from the managed care support contractors by the Department of Defense for investigation is stunning.

So let me pause for a moment here, if I may, Mr. Shays, and let us turn to Mr. Backhus here and let us try to put the ketchup back in the bottle. Mr. Backhus.

Mr. BACKHUS. I am not sure what you are asking me.

Mr. BUYER. What I am asking here is, of the \$580 million, what all is that and give us your judgments here or your observations about why the Department is giving the answers that they are giving here.

Mr. BACKHUS. I suppose the first thing I need to say is that I doubt—I would say it would be impossible to ever, ever pinpoint or be precise as to what this upper limit is. The estimates that comprise or make up \$580 million come from a number of different sources, from people in the business who are talking 10 to 20 percent. It is fraud, waste, and abuse, not just fraud, necessarily. It is important to distinguish and to make clear that it is not always criminal kinds of fraud but there are over-billings and things like

that, possibly unnecessary care and things like that which are included in this. So that accounts for, I think, the difference, potentially, between 3 percent and something in the neighborhood of 10 to 20 percent. So we are talking about lots of things here.

The activity—in response to the report that we wrote last year on this, the Department has been responsive in several ways. Giving it attention was the first order of business here, and there was at the time nothing in the way of strategic planning or emphasis, in terms of management attention, that we could see that existed. Since that time, there is now in place an emphasis that has been placed on this from the top. They do have prepayment edits. They identify over-billings in some cases and things like that.

But in preparing for this hearing today what we tried to do was to find out exactly what has changed in the way of additional kinds of analysis, mostly in an automated way, that are being made of the claims that are submitted, either provider profiling, trending, patterns, billing practices, at the contractor level. This is a level above where Mr. Meyer works—the people that he contracts with to process claims.

There is software available around to do this that matches claims together to determine potential issues involving fraud, mostly. The software is available. The Department of Defense has identified that software and wants their folks to use it, but as I understand it, this stuff is not going to be loaded by the contractors until the end of this fiscal year, sometime in the September-October time frame, and until that happens, I suspect that we are going to see much the same kind of—

Mr. BUYER. Of the \$580 million. So you have got the fraud side of it, you have got abuses of the systems, and then you have waste, and that is sort of what we are looking at here, is how we bring efficiencies to the systems.

Let me shift gears for just a moment. This is a unique opportunity, so I have to ask this question. We conduct our hearings on the Armed Services Committee. We work with you. We sort of move toward solutions. Now you have an opportunity to examine what we have placed in the Defense Authorization Act. We chose not to give you an actual mandate, come in and mandate, and we talked about some of those concerns. But what we gave you was a goal, to move to 50 percent of the non-pharmaceutical claims.

Do you know what that sort of is? We are telegraphing exactly where we are coming from. We want to see if you can achieve the goal, because if you do not achieve the goal, you know exactly what Congress is going to do and it will be mandates. So my question to you is, how realistic will you be to achieve the goal so we do not micromanage? Dr. Sears.

Dr. SEARS. Are you asking if the goal is realistic?

Mr. BUYER. I want to know if you can achieve the goal without Congress having to mandate electronic filing. Can you do it on your own?

Dr. SEARS. We certainly feel that that is achievable. As Mr. Meyer has pointed out, it is difficult, but we will certainly—I think the 50 percent level is going to be difficult and I would just be repeating what has been stated before in testimony, but we certainly have a full court press in terms of our attempts to convert, particu-

larly as you stated in the legislation, that we would, identify the high-volume providers. We have directed the Secretary to identify the high-volume providers in an attempt to get that level up to 50 percent, and we will pursue that vigorously. I have—

Mr. BUYER. Let us be specific. Full court to achieve, full court press to achieve is your quote. What is the date to implement a web-based system of open architecture? When is that going to happen? Give me an idea. It was supposed to have occurred by May. Is it going to happen? I mean, if you can say full press, that should have happened by now. When is this going to happen?

Dr. SEARS. As you know, our contracts are established and requirements are put in those contracts that are met. Changes in those change. Some of the web-based systems are currently online. They are in place. They are being utilized. In terms of looking up the status of claims and other enhancements will go on those.

As Mr. Meyer mentioned, they are moving toward the utilization of web-based capability to submit claims. Those things are underway. We are supporting with our contractors discussions that may lead to other approaches to this. So there is activity, there are things in place, and this is progressing.

But it will take new contracts to bring a total system across—a total approach across the system, which is one of the things that is difficult that we cannot move as rapidly as we would like to and as we see the right way to move. But in the meantime, things are going into place and in the new contracts, with the requirement that our contractors use best business practices, obviously, a good share of those things will be a part of those new contracts.

Mr. BUYER. Mr. Chairman, may I have one more? I think this has been very helpful and productive and I want to thank the Budget Committee. We have talked about different pillars here relative to why it costs so much, whether it is front costs, inquiry costs, how we can reduce actually the human element in touching this administration.

Mr. Meyer, I think your testimony was very helpful. The theme I received from your written testimony is about the complexity of the claims processing. I think the other pillar is the complexity of these claims versus Medicare. So in our system, you have got to look at it and you say, well, how do we move to data warehousing? Right now, you go, OK, a claim. Are they active, pending, TRICARE, standard, prime, senior, extra, how were the rates negotiated, portability, who pays what, competition between regions, not my responsibility.

Mr. MEYER. Right.

Mr. BUYER. Wow. So how do we move toward streamlining, all right, and I would be interested in your views here. Actually, for all of you gentlemen, how do we move toward streamlining, reduce the complexity without actually reducing the benefits at the same time?

Mr. MEYER. I think the Department has begun to do that. I think the work simplification efforts in the past year are beginning to get away from the fact that 14,000 electrocardiograms had deferred the year before for somebody in my shop to look at the paper and say it is appropriate and pass on. That is times 400 other deferrals just like that. That has begun. The Department has told us, do away

with that. That does not make any sense. That is a carryover from the CHAMPUS days. So that is being done away with and that will simplify the program.

I think Mr. Backhus discussed earlier today one of the big hang-ups on electronic claims has been our being unable to accept the Medicare provider numbers. The Department has now said, you can now accept the Medicare provider numbers. We have to build a crosswalk system behind it, but that is an impediment that is being blown away. So one by one, these things are coming away.

I guess my caution is that nobody should believe that at the end of the day, when all of it goes away, we are going to be at \$1.78, because we are not.

Mr. BUYER. Mr. Backhus or Dr. Sears? Dr. Sears, then Mr. Backhus.

Dr. SEARS. Obviously, the example I gave in my opening statement about ultrasounds is another one of the examples. As we determine things that have no yield, that do not reduce health care costs or improve quality, those things are being removed. I could provide for the record, if you wish, a very extensive list of specific initiatives that are being undertaken to remove the complexity, unnecessary edits, and other approaches that we are using to simplify claims.

Mr. BUYER. Mr. Chairman, Dr. Sears has offered it to the Budget Committee and I think it would be helpful, if you would so order.

Mr. THORNBERRY. We will look forward to receiving that list. Thank you.

Dr. SEARS. Very fine.

[The information of H. James T. Sears, M.D., follows:]

CLAIMS PROCESSING RE-ENGINEERING STATUS REPORT

Improvements already implemented or in progress to address the need for process simplification, improved timeliness of claims processing and increased electronic claims submission include a work simplification contract modification, a comprehensive expert consultant review of the claims process, partnering with contractors to initiate improvement and investigation of e-commerce options.

Work Simplification Initiatives: Fully implemented by Fall 2000, modifying current contracts to eliminate unnecessary or duplicative processes that interfere with optimal performance in claims processing, emphasizing the use of commercial best practices and Medicare procedures, where possible. Changes implemented were:

- Simplified Provider Authorization Process; implemented Summer 1999;
- Eliminated Prescriptive Controlled Development; implemented Summer 1999;
- Increased Claims Processing Cycle Time Standard; implemented Fall 1999;
- Allowed Commercial Best Practices for Utilization Management; implemented Spring 2000;
- Changed Third-Party Liability Collection Approach; Final Regulation and implementation Fall 2000; and
- Increased Transition Time (between award and start work date) to a minimum of 9 months (to be included in all future contracts).

Consultant's Comprehensive Evaluation and Assessment Recommendations: Completed in November 1999, resulting in initiatives that will be implemented throughout 2000. The goal of these changes is to improve beneficiary and provider satisfaction through improved claims processing timeliness and reduction of deferrals or denial of claims. Initiatives identified include:

- Increase Electronic Claim Submission and Auto-Adjudication;
- Improve Customer Service, Provider Education and Beneficiary Education;
- Enhance Management Reporting Capabilities and Program-Wide Data Quality;
- Improve Enrollment and Eligibility Process; and
- Enhance Fraud and Abuse Mitigation Capabilities.

Partnering With Managed Care Contractors: One key strategy to implement recommended changes is ongoing partnering with the managed care contractors.

Meetings were held in January and April 2000, focusing on improvements that could be implemented quickly and that would eliminate root causes of re-work, increase first-pass rates, remove barriers to EMC and Auto Adjudication, and decrease deferrals. Initiatives were approved in the following areas:

- *Provider ID*: An interim solution was developed, allowing the use of the Medicare Uniform Provider Identification Number for provider identification on TRICARE claims, with the claims processors developing the TRICARE ID (Health Care Provider Record) from internal resources. This change will facilitate electronic claims submission.

- *Performance Reports Streamlining*: Unnecessary reports have been eliminated, some reports have been placed on an ad hoc or annual basis and the routine monthly reporting has been reformatted and simplified.

- *Health Care Service Records*: Edits have been eliminated, where possible, and investigation is under way, in cooperation with the managed care contractors, to implement the new TRICARE Encounter Data system as soon as possible.

- *Coding and Pricing Update Process*: The annual processes for updating CMAC and DRG rates and for providing coding updates has been streamlined to ensure that claims are not delayed due to these processes.

- *Performance Audit Process*: Extensive changes and streamlining to this process have been undertaken with the goal of reducing the contractor's resource investment in auditing, while maintaining a strong TMA oversight of performance, allowing the contractor to refocus resources on claims processing.

- *Claims Deferrals*: Changes have been authorized to allow contractors to use their best business practices in determining the need for pre-pay review of claims. Examples include use of Durable Medical Equipment Regional Carriers' pricing where no CMAC exists and there is not sufficient data available to set a locality price, review of consultations versus office visit codes for specific provider specialties and annual rather than per claim review of MTF Durable Medical Equipment status. These changes improve auto-adjudication of claims, decreasing processing time and reducing costs by eliminating the need for manual intervention.

- *Third Party Liability Handling*: The regulation change necessary to implement this change has been finalized, and implementation is expected by the end of 2000. This change will eliminate delays in claims processing due to Third Party Liability issues.

Implementation plans have been developed and changes will be implemented throughout 2000 and 2001. The next partnering meeting is planned for October 2000, focusing on implementation status for the initiatives identified in previous meetings, preparation for the Coding and Fee Schedule update process that will take place in early 2001, discussion of Web-based applications for beneficiary or provider access to information and web-based claims processing options. These meetings have been well received by the managed care contractors and will be continued throughout 2001.

Electronic Claims Processing and Web-based Applications: Initiatives recommended by the managed care contractors are under investigation and internal strategy development has been undertaken to determine how available technology can be properly utilized to facilitate claims processing and customer service, in conjunction with implementation of national HIPAA standards.

Debt Collection Assistance Officer Program: The Department is moving to rapidly implement a new program to assist our military families in addressing notices of debt collection. The Debt Collection Assistance Officer Program will provide a single point of contact for our service members for assisting in resolving debt collection issues. Assistance officers will be located at each Military Treatment Facility (MTF) and TRICARE Lead Agent office. Once contacted by a TRICARE-eligible beneficiary, the debt collection assistance officer will intercede with all agencies involved, including military personnel offices, the MTFs, lead agents, network and non-network providers, the TRICARE Management Activity, managed care contractors, and debt collection agencies when appropriate, to resolve a collection issue arising from a TRICARE claim. The officer will research the claims history with the priority unit at the claims processor, and notify the beneficiary of the resolution. If appropriate, written documentation will be provided for use with national credit reporting companies in removing unwarranted adverse credit information related to TRICARE claims. Servicemembers in remote locations may contact any debt collection assistance officer who is convenient for them. An implementation team of representative from the TMA, the military Services, and the Lead Agents are currently working to define implementation parameters.

Mr. BUYER. I did not mean to interrupt. Were you concluding you would provide it to us written?

Dr. SEARS. Along all these lines, there are tremendous efforts underway to move this along. There are certain very significant impediments that we face that make it difficult to simplify or do some of the things that we would like to do in the system, and the fact that we have open enrollment, or that we do not have all of our members enrolled, is a significant impediment to us, and there are other issues like that that make it difficult to negotiate. But where we can find solutions, where we can remove these impediments, that is being done right now.

Mr. BUYER. Mr. Backhus.

Mr. BACKHUS. Well, we have obviously taken the position that we have positive reactions to all the initiatives underway. We have been monitoring them but have not evaluated them up to this point in detail. But they are clearly the right things to do.

The only concern I really have at this point is, I guess I am hearing the same thing from you, and that is how long is it going to take? I have seen a number of initiatives come and go in the past, so I will be looking here for sustained commitment to make these kinds of changes. I think, in many respects, these folks know what to do, but this bureaucracy sometimes just kind of makes it hard to do.

Mr. BUYER. Thank you, gentlemen.

I want to thank the Budget Committee for permitting me to sit with you here as we explore these issues. I think they are extremely important, and I also want to compliment you as you work in a bipartisan fashion. This is a really important issue to the troops out there because what happens is exactly what both of you had mentioned earlier, and in particular Mr. Moran.

I do not necessarily agree with Dr. Sears' testimony earlier about that, well, all these payments are being made timely. They are not being made timely. Some of the contractors are not getting paid on time and then they take those bills and they drop them right on the soldiers and the soldiers do not have the money and then they end up with all of the bad credit ratings and, guess what, guys, they call us. So it is a system that begins a vicious circle. It is circuitous.

So I think all this is very important, and the more light we shine on this, the more we can move to productive solutions. I want to compliment the Budget Committee. We from the House Armed Services Committee would enjoin and work cooperatively with you in the efforts toward moving toward a solution. Thank you, gentlemen, for the bipartisan effort.

Mr. THORNBERRY. We appreciate the gentleman participating. He has added a lot in trying to get to the heart of the matter and we thank him for his time.

Mr. Moran.

Mr. MORAN. I do not have anything further to add because I think the questions that needed to be asked have been asked. I just had one thing that I cannot figure out right away.

You said that it costs on average \$2 extra to do the processing the way that you feel you have to do and that the principal reason is because these providers, they just do not have enough claims to make automation make sense, to automate it completely, because it costs on average 35 cents per claim, or it would cost the provid-

ers 35 cents per claim to automate their system, as I understand it, on average, and why should they incur that expense.

But why could you not incentivize it by saying, we will pay you, not only give you free software but we will give you 50 cents a claim. So if it costs you on average 35 cents a claim, we will give you an extra half-buck per claim. So now you have no economic reason not to automate it and we are better off, the Defense Department, because we are saving \$2 a claim. Can we not give them some of the money that we would save, or am I missing something?

Mr. MEYER. You, in fact, can do that. That would be up to—I am a subcontractor. That would be up to the prime contractor, because that money would have to come out of their pocket, to make that decision.

One of the issues in making that decision is right now there are many providers who are paying for the service. So if I am paying for the service and the guy next door to me all of a sudden starts getting paid for the same thing, I just created chaos inside that network. I am just speaking frankly, what would happen. Everybody that is currently paying for the service the next day is going to say, I am not paying for it anymore. It might be a good thing to happen, but that is what would happen and there would be an interim period of time where there would be chaos going on because some guys are paying for something somebody else is being paid to do.

Mr. MORAN. But our interest is in reducing that \$2 extra that is attributable to the non-automation.

Mr. MEYER. Clearly.

Dr. SEARS. We pay claims at the maximum allowable rate, so theoretically, under the law, we could not add money to that rate.

Mr. MORAN. You cannot by law?

Dr. SEARS. We pay at the maximum allowable rate.

Mr. MORAN. Could the authorizing subcommittee do something there that would enable them to incentivize it so that it does not cost 35 cents, on average, a claim?

Mr. BUYER. If the gentleman would yield.

Mr. MORAN. I would love to yield.

Mr. BUYER. Obviously, it is worth looking at. I mean, no matter what the system is out there in government, whenever we can—whatever investments we also make to reduce costs and save money is smart business. You brought up something worth looking at. Thank you.

Mr. MORAN. Thank you, Mr. Buyer. Thank you, Mr. Thornberry, and thanks to the witnesses. I know you are trying to do as good a job as you can under the circumstances, and I do think that TRICARE, particularly TRICARE Prime, is going to get better as time goes on and that you are going to be able to automate more. I think that we all have the same objective. It just is frustrating to see this very high differential. You have explained why the differential exists, but it still is unacceptable in the long run and I trust that that gap will be narrowed because we are going to continue to be criticized for letting the system go on where the costs are so much higher than it costs HCFA. While we may understand that and may be sympathetic, it just lends itself to constant criti-

cism and more and more GAO reports. But as you say, the process for automation is ongoing.

Why were you smiling there, Mr. Backhus?

Mr. BACKHUS. Dr. Sears got a chuckle out of more GAO reports. I agree.

Mr. MORAN. But do you not agree, until we narrow the gap, it is just easy pickings, and particularly for the Congress. But I know that the people involved are trying to do a good job and do the right thing. I do not have any sense that anybody is trying to rip off the system. And while we may have a lot of fraud, we have more fraud in HCFA, and I do not think fraud is the problem. I think we have a system that simply needs to be modernized and needs to be more subject to the information technology that is available. When you have small providers, you can understand why they just do not want to automate their system for a handful of claims. It does not make sense from their point of view.

It has been useful. Does our colleague, the ranking member of the full committee, want to have a final word of wisdom?

Mr. SPRATT. I just wanted to, if I could take a second and ask Mr. Meyer what has been your situation recently with respect to your own receivables from the Department of Defense.

Mr. MEYER. We have a problem there, Congressman Spratt. We are owed about \$40 to \$50 million in back payments.

Mr. SPRATT. At this point in time?

Mr. MEYER. Yes.

Mr. SPRATT. Is that high or low relative to the past?

Mr. MEYER. It is extremely high. We have two situations on two contracts where the government estimated claim volume came up way short of the actual claim volume and reasonable equitable adjustments were put forward. We have been working on them two to 3 years now. One of them did settle. The other one is still pending, and of that \$40 million, most of it is wrapped up in that one settlement.

Mr. SPRATT. And was the fee that you, or the proposal that you made in the bidding for this contract predicated on a certain volume of claims processed?

Mr. MEYER. Yes, sir. In all five contracts, the government provided the claims volume estimate and said, bid your staffing and your dollars on your receiving this number of claims.

Mr. SPRATT. And what was their estimate, claims volume?

Mr. MEYER. It was different on each contract, but, for example, on the contract that is not resolved yet, the government estimate was five million claims per year.

Mr. SPRATT. And what did—

Mr. MEYER. In fact, we got seven-and-a-half million.

Mr. SPRATT. So it is off by 50 percent?

Mr. MEYER. Right.

Mr. SPRATT. Under by 50 percent.

Mr. MEYER. Correct.

Mr. SPRATT. And has this been a continual frustration, or has the basis for bidding improved as experience has gone on?

Mr. MEYER. The basis for the claims volume did improve in the last two contracts. In the last two contracts, the government actually asked us what we thought the volume would be and we jointly

agreed on what the volume probably would be and, in fact, were right on the last two contracts. But it is the earlier contracts that still are not resolved that create the financial problem for us.

Mr. SPRATT. So does this indicate that in structuring this system, DOD underestimated what the administrative complexities and volume of claims processing was likely to be?

Mr. MEYER. Well, certainly the claims volume was underestimated.

Mr. SPRATT. What about, since you participated in this, the difficulties building the network? Do you think that the assumptions going into this were a bit too facile about how you would build a network?

Mr. MEYER. The problem that you have with this program with building the network is that the requirements are the same for 100 percent of the geographic area of this country, although the practice of medicine and distribution of the physicians is not the same. So the requirement for numbers of doctors in a network, for example, in Portsmouth, Virginia, where there is a high concentration of military retirees and active duty military and their families, is the same as it is for Rock Hill, where there are not very many military retirees. So even though things are not the same, they are tried to force to make to look like the same.

Mr. SPRATT. Dr. Sears—

Mr. MEYER. Dr. Sears has done a great job working with us in trying to get that resolved, and Dr. Sears, to his credit, in the resolution of the REA has been the single person who has been trying to push to get the thing resolved more than anybody else. We wish we could get that kind of initiative underneath Dr. Sears.

Mr. SPRATT. How is it your largest contractor, you are \$40 million in arrears on the payment of its account?

Dr. SEARS. I am pleased to be able to say that we are close to resolution of those REAs and the money for the prime that will be passed to the sub will be forthcoming.

Mr. SPRATT. Humana? You said the prime is—I may have misunderstood your—

Dr. SEARS. I did not say, but it is Humana.

Mr. SPRATT. Has this been a learning process for DOD? Do you think the Department underestimated the complexity of putting in place a national managed care network?

Dr. SEARS. There were many factors that—yes. As Mr. Meyer said, we are trying to put a uniform benefit in place across the country, and I worked actually for a contractor in California and it was very easy to build networks in San Diego and Los Angeles and San Francisco. It was very difficult to build networks in places like Monterey and to bring the same benefit and get the same advantages to the contractor and the government in those places.

We also, as you know, have been going through some very significant changes in health care and in the military health care system. With the significant downsizing of military medical facilities, the conversions from hospitals to clinics, there are just a myriad of things that affected the—and the utilization, switching from a system where the beneficiary was the primary person who submitted claims to a system where the provider submits the claim in 97

percent of the cases. There were a number of factors that increased the number of claims over what the government projection was.

So yes, there were lessons learned and the example that was just used was one of those lessons, talking to the claims processor about what their anticipated numbers were and sitting down together and figuring out what a more likely number was and then going forward with that. That has been a feature of the program. This is a program that came up essentially in 1995 and is now world-wide and has had some growing pains, but tremendous progress has been made.

Mr. SPRATT. One final question. In our State with TRICARE, we have experienced—first of all, it took a while to fill out the network and now we are seeing repercussions to the rates of reimbursement of pay and there are pieces of the network that are sloughing off, providers pulling out, both hospitals and physicians. Is this a problem nationwide?

Dr. SEARS. It is a problem in some localities. As I say, where there are concentrations of providers, where there is some competition among providers, that is not an issue for us. In the communities where there are stand-alone providers or sole community hospitals, those sorts of things, it is more of an issue for us. The reimbursement rate, as you know, is at the Medicare level. CHAMPUS used to reimburse at higher levels than that. So we are experiencing some of the same things in terms of provider participation, actually, that Medicare is experiencing in terms of providers dropping out of the network.

Mr. SPRATT. So TRICARE rates equate to Medicare rates?

Dr. SEARS. We are required to have our rates at Medicare rates and that has been accomplished. There are a few of our rates that are somewhat higher, but those are for things that Medicare generally does not do, like deliveries and things of that nature. But yes, our rates are at the Medicare level.

Mr. SPRATT. Thank you very much.

Mr. THORNBERRY. Dr. Sears, have you made a request for money or some authorities to help improve the efficiency of claims processing that has gotten stopped while going up the chain?

Dr. SEARS. As you know, funding for the DHP is an issue and there are funding—

Mr. THORNBERRY. So you have made funding requests that basically get reduced before they get to the Congress?

Dr. SEARS. We do not have enough money to do all the things we want to do, yes, sir.

Mr. THORNBERRY. I think that was yes. OK.

I appreciate the testimony from all of you today. I think it certainly has been helpful. I am left a little bit with the feeling that we have a health care system that has some dissatisfaction among beneficiaries, some problems among providers, and to try to keep providers there, we are having to do things to try to be nice to them, paper filing in 2 weeks and the rest, that is more expensive and helps reduce care and puts further strain on the budget, which kind of gets to be a vicious circle. Hopefully, we can break out of that sort of thing.

I think at a minimum, we have got agreement that we can at least save \$3 a claim if we get everything right, and certainly if

there are—you were talking about the incentives and the things that Mr. Moran was talking about. If there are other authorities that any of you see would be helpful in getting us to save that \$3 or \$4 quicker, well, then please let us know.

If that is all, then we will call this hearing adjourned. Thank you all.

[Whereupon, at 12:20 p.m., the Task Force was adjourned.]

Pentagon Financial Management: What's Broken, How to Fix It

THURSDAY, JULY 20, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
TASK FORCE ON DEFENSE AND INTERNATIONAL RELATIONS,
Washington, DC.

The Task Force met, pursuant to call, at 10:05 a.m. in room 210, Cannon House Office Building, Hon. Christopher Shays (chairman of the Task Force) presiding.

Chairman SHAYS. I would like to call this hearing to order, the Budget Committee Task Force on Defense and International Relations on Pentagon Financial Management: What's Broken, How to Fix It.

I welcome our witnesses and I welcome our guests. As defenders of freedom and the instrument of U.S. policy when force is required, our military is unsurpassed. But as a steward of the public funds entrusted to it, the Department of Defense, DOD, enters the new century captive to the wasteful fiscal habits of the last.

It seems the guardian of the new world order keeps accounts like a Third World banana republic. Audits have found hundreds of millions wasted on inefficient, duplicative information systems, billions in excess inventory and trillions of dollars in unsupported accounting adjustments.

In 1999, DOD reported problem disbursements totaling more than \$10 billion, more than half of which could not even be matched to a valid invoice or contract. The true extent of DOD overpayments can only be inferred from the \$5.3 billion voluntarily returned by contractors between 1994 and 1999.

A recent report disclosed the Pentagon has been miscalculating simple payroll withholding taxes for many civilian employees.

Due to these and a myriad of other persistent systemic accounting problems, the Department is unable to comply with Federal laws requiring annual financial statements and other management controls. Sadly, these problems are not new and reforms spawn only more reforms, pushing promised solutions over the budgetary political horizon.

We convene this Budget Committee Task Force hearing on DOD financial management practices this morning to discuss not just the extent, but the impact of these chronic problems, and what the Department is doing to get its fiscal house in order. In an enterprise as vast and costly as the Department of Defense, effective business systems are not peacetime luxuries that occupy lawyers and accountants. Today's generals, admirals, colonels, and captains

rely on management information to support their core mission. The projection of global power requires the production of timely and accurate data on troop readiness, supply inventories, equipment performance and much more. The link between ledgers and lives is very real.

The Government Reform Subcommittee on National Security, which I chair, recently heard sobering testimony from the DOD Inspector General on the prosecution of a company knowingly providing substandard protective suits for use against chemical and biological weapons. The IG found more than financial fraud. The lack of effective inventory controls prevented rapid segregation of the defective suits. Some were sent to deployed troops in high-risk areas. U.S. Forces were put needlessly at risk.

This year the House authorized \$306 billion for defense. Current projections call for increased defense spending in the years to come. Our constitutional obligation to provide for the common defense and our fiduciary obligation to protect public assets dedicated to the effort demand a system of modern financial and management controls that can account for those dollars from beginning to end and at every stop in between.

That is not the case today, but DOD has plans to simplify current processes, eliminate incompatible data sets and standardize some transaction and inventory codes across programs and service branches. Our witnesses today have been asked to discuss these initiatives and the challenges still confronting the effort to transform last century's quaint bookkeeping into the modern business of defense.

As I said before, we welcome their testimony. At this time, I would call on Ms. Hooley, the ranking member of the Task Force.

Ms. HOOLEY. Thank you, Mr. Chairman, for convening this hearing—I should turn on my mike—Pentagon Financial Management: What Is Broken, How to Fix It.

We have before us today three distinguished witnesses, Mr. Bill Lynn, Comptroller of the Department of Defense; Mr. Robert Lieberman from the Office of Inspector General of the Department of Defense; and Mr. Jeffrey Steinhoff from the General Accounting Office. I thank you for coming before this committee today and look forward to the testimony from all of you.

Congressman Moran is the ranking member of this Task Force, but he is also ranking member of the District of Columbia Appropriations Subcommittee, which is in markup this morning. He sends his regrets that he will not be able to attend this important hearing.

From the stories of overpriced hammers and toilet seats that garnered great attention in the 1980's to anecdotes we will hear today from our witnesses, it is obvious that the Department is still struggling to establish a fully reliable and accurate financial management system.

To some extent we should not be surprised, because the Department is so large and complex. The defense budget represents about 16 percent of all Federal spending and is almost one-half of the entire discretionary budget. The Defense Department employs almost 3 million military personnel and civilians and has facilities in more than 100 countries. It has millions of items in its inventory, rang-

ing from simple screws to the world's most complex weapons systems.

The Department's system of financial management was born and raised during the Cold War when the threat of conflict with the Soviet Union took primacy over other considerations, including financial management. After the fall of the Berlin Wall and the end of the Cold War, both Congress and the Department started paying much closer attention to financial management issues.

In 1990, Congress enacted the Chief Financial Officers Act, establishing a CFO for each of the 24 major agencies, including the Defense Department. The Government Performance and Results Act of 1993 and the Government Management Reform Act of 1994 established statutory financial management standards for the Department of Defense and other agencies.

Frankly, the financial management systems developed during the Cold War were overwhelmed by the standards of the 1990's. The Department is in the midst of revamping its financial management systems to meet today's standards. The Department has made progress, and I hope our witnesses will tell us about that progress that they have made to date, and by all accounts, the Department still has a long way to go.

The issue before us today is not a partisan issue, but rather a long-standing and daunting problem that both Republican and Democratic administrations have struggled to overcome. I appreciate the title of today's hearing because not only should we know what is broken with the Pentagon financial management system, but more importantly, we need to discuss how to fix it.

I look forward to the testimony of each of the witnesses.

Thank you, Mr. Chairman.

Chairman SHAYS. Thank you very much.

At this time, I would call on Mac Thornberry, who is co-chair of this Task Force and also serves on the Armed Services Committee.

Mac.

Mr. THORNBERRY. Thank you, Mr. Chairman.

It is my opinion that defense is the first function of the Federal Government, and it is also my belief that we ought to spend whatever resources are necessary to do the job. But if defense is that high a priority, it makes it nearly even more—it makes it even more disturbing to me that we have the continuing problems that we have in the Department of Defense; and I think, in a lot of ways, it makes it less forgivable.

When we have such serious problems, which Mr. Lynn is well aware of, trying to come up with increased pay and benefits so that we can get and keep top quality people, when Congress has to put more money every year into the Department of Defense health care system, when we have shortages of a serious nature in research and development and other critical accounts, it is even more disturbing that we don't know where our money is spent, and we don't know how much of it is wasted and how much of it is spent on 30,000 accounting people and to try to deal with this cumbersome, outdated, indefensible system.

I agree with Ms. Hooley; of course, it is a long-term problem, and it is not just one administration and it is not going to have just one fix. But it also seems to me that fixing the problem has not gotten

priority from the top leadership at the Department, and that is—and it is going to have to have that.

It also seems to me that we in Congress need to provide part of the solution, because big bureaucratic organizations are hard to change; and in the past, there have been several examples where it has taken an act of Congress to give the Department a nudge, or even a shove, into fixing the problems that need to be fixed. We did that with Goldwater-Nichols in reorganization. Congress did it last year with the Department of Education and the nuclear weapons complex. We mandated reorganization and changes. We may have to do some of that here.

And so I look forward again not just to hear what the problems are, but what the answers are. We need to be part of that solution, but we have to have a solution and it needs to happen quickly.

Thank you, Mr. Chairman.

Chairman SHAYS. Thank you very much, Mr. Thornberry.

Mr. Bass, do you have any comments?

Mr. BASS. No statement.

Chairman SHAYS. Thank you. Let me welcome all three of our witnesses, and I will announce them and then we will begin with the first individual I am introducing, William J. Lynn III, Under Secretary of Defense, Comptroller and Chief Financial Officer.

We also have Robert J. Lieberman, Assistant Inspector General, Department of Defense.

And then we will also have Jeffrey Steinhoff, Assistant Comptroller, General Accounting Office.

And, Mr. Lynn, let me just say to you, I appreciate your appearing with the Department of Defense Inspector General and the Acting Assistant Comptroller General. Sometimes we just have the Department testify alone, but it will enable us to have a better dialogue. And also I realize that we basically have two who kind of examine the Department of Defense and are, in some cases, critics of the attempt to show how it can be approved. But we will welcome anybody else that you want to have respond to a question if you think they might be able to respond to it better.

But at this time, let me welcome you, Mr. Lynn, and you have the floor.

STATEMENT OF HONORABLE WILLIAM J. LYNN, UNDER SECRETARY OF DEFENSE (DEFENSE) AND CHIEF FINANCIAL OFFICER

Mr. LYNN. Thank you very much, Mr. Chairman. I appreciate the opportunity to be before the committee to discuss this important issue. I particularly appreciate, Mr. Chairman, your offer that I can call on help if I get over my head.

I would ask that my formal written statement, more exhaustive treatment of the issue, be treated as part of the record.

Chairman SHAYS. Let me just say that all the witnesses may ask unanimous consent that their entire statement be submitted for the record, if they want to just speak on part of it. And I also ask unanimous consent that all members be given, as well, 5 days to submit written statements for the record.

Without objection, so ordered. Sorry to interrupt.

Mr. LYNN. Thank you, Mr. Chairman.

Let me begin by respectfully disagreeing with Mr. Thornberry. Financial management reform has been a high priority of this Department in the two terms that I have been a part of it, and it has been a particularly high priority under Secretary Cohen. He has had long experience with this from the congressional side, and he has paid personal attention to these issues. And I would be happy to go into that in more detail if you would like.

That said, there is—as Ms. Hooley indicated, substantial work to be done. I am encouraged by the substantial progress that we have made, the commitment that our people have toward that progress. But we indeed have much left to do.

What I would like to give you today is a status report on our major initiatives and highlight the challenges ahead. While the Department has had notable successes in its financial management reform efforts, the reality is that it is impossible to overhaul our financial management operations overnight. The planned reforms will require several years to fully implement, as the chairman indicated, and nonetheless, though much remains to be done, we have made much solid progress.

The analogy you might give here—the chairman, I think, indicated correctly that we inherited an accounting system that was not only outdated, but was intended for different purposes than it is being asked to do today. For 200 years, the accounting systems that we had were essentially to mark and track the obligation of funding along the lines that Congress appropriated it. Towards that end, the systems are actually quite strong and are able to do that.

What we are trying to do today is to move into a more business-like case where we can do accrual accounting, not just obligations and disbursements, but to do a business style accrual accounting. That is important in terms of estimating costs, in terms of trying to allocate costs toward decisions that understand the implications of the various far-reaching choices the Department is faced with.

But it is a mammoth task. It is akin to driving a very large car at 60 miles an hour, and we are going to have to change all the tires and overhaul the engine, and we are not going to be able to stop the car. We still have to continue to do all of the things that we are doing, pay all of the people, pay all of the contractors to do all of the financial management of the Department, and at the same time overhaul it. So it is a very difficult process.

The financial reform effort that Secretary Cohen has laid out has three major phases.

The first phase is to consolidate our financial management operation. That phase is largely complete. We have consolidated over 300 finance and accounting field sites, scattered throughout the world, into 26 locations. That, in and of itself, has produced substantial savings, over \$100 million a year. But more importantly, this organizational consolidation has enabled the second phase of financial management reform, the elimination of incompatible and noncompliant finance and accounting systems. This phase is well under way. The number of noncompliant finance and accounting systems has been significantly reduced.

In 1991, just prior to this administration, we had 324 systems, and none of them met today's accounting requirements. Today we

are down to 96. By 2003, we will be at about 30 finance and accounting systems. That is a 90 percent reduction in less than a decade, and we expect all those finance and accounting systems to be compliant with current accounting requirements.

That leads to the third phase which we have recently initiated. The third phase involves upgrading the interfaces with the functional systems that feed data into the finance and accounting reports. A little-known fact is, more than 80 percent of the data on DOD's financial statement comes from outside the finance and accounting systems. The data comes from personnel, acquisitions, medical, logistics and other systems necessary to perform the defense mission. Establishing a seamless connection between these so-called "feeder systems" and the accounting systems used to prepare the financial statements is the crucial final step in financial management reform.

These steps were developed and put in—these systems, excuse me—were developed and put into service long before the promulgation of Federal accounting standards. They simply were not designed to produce business-type financial statements. Accordingly, much of our financial information has to be manually transferred from these systems into the accounting systems, and some of the information that the auditors insist upon is simply not available in these systems they were never designed for.

Mr. LYNN. For example, most of our inventory systems are designed to maintain records on the latest acquisition costs. This is the data the logistics managers find the most critical. These systems, however, do not retain historical costs, which is the data the auditors would like to see.

We are moving to upgrade our inventory systems to retain both historical and latest acquisition costs, but this is an expensive and laborious process. This type of effort can be repeated through the acquisition area, through the medical area, through all the logistics area; and that is what encompasses this third phase of financial management reform. It extends well beyond the financial arena to touch nearly every other function of the Department.

To oversee this massive effort, to oversee the effort that is going to be needed to bring these areas into compliance with new accounting standards, we have established a Y2K-like panel. This panel will report to the Deputy Secretary of Defense through the Defense Management Council. The panel will establish milestones to move the 70 or so critical feeder systems into compliance with current accounting standards.

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

Toward that end, we have collaborated with the organizations and the individuals represented at this table. They have helped us 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 which 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 coordinated. Details of these strategies are discussed in my written statement. I would be happy to go into them in questions.

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

Our DOD leadership team has always 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 activities that aren't fulfilling it. We have 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 they enhance, not diminish, the Department's management and leadership. We believe we have a plan to do just that.

Thank you again, Mr. Chairman.

Chairman SHAYS. Thank you, Mr. Lynn.

[The prepared statement of William J. Lynn follows:]

PREPARED STATEMENT OF HON. WILLIAM J. LYNN, UNDER SECRETARY OF DEFENSE
(COMPTROLLER), CHIEF FINANCIAL OFFICER, U.S. DEPARTMENT OF DEFENSE

Mr. Chairman and members of the Task Force, it is a pleasure to be here to discuss financial management within the Department of Defense.

Today, I would like to summarize the comprehensive financial management reforms currently underway within the Department. In particular, 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

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 are 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 is pursuing 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 May 2000, 95 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 80, 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 Depart-

ment 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 Depart-

ment'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 specialties 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 require-

ments 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 Task Force Members for providing me this opportunity to address financial management reform within the Department of Defense. 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.

Chairman SHAYS. Mr. Lieberman.

Mr. LIEBERMAN. Thank you, Mr. Chairman.

Chairman SHAYS. Excuse me, Mr. Lieberman. I just want to point out that we are fortunate to have the ranking member of the full committee, John Spratt, here; and I welcome you to the meeting. Thank you.

Mr. SPRATT. Thank you.

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

Mr. LIEBERMAN. Mr. Chairman and members of the Task Force, thank you for the opportunity to participate in this hearing this morning.

You asked me in your invitation letter specifically to discuss the results of our financial statement audits. The first part of my written statement talks about basically how the Department ended up in the situation that it is in today, and I won't dwell on that in detail because references already have been made to it.

For decades, as a decentralized operation, Defense, like most other government agencies, did not do a particularly good job of moving into the computer age on a controlled basis so that we would have systems that talk to each other and fully meet user requirements.

During the 1990's, there has been a gradual but major transformation of the way the Department does business. There are several reasons for this. One is the advance of information technology. Particularly the Internet makes it much easier to move information among organizations and between locations more efficiently and faster than ever before. There has been a powerful example set by the U.S. private sector in how to harness modern information technology and use it to develop new business practices that are far more efficient than the practices of the '70's and the '80's.

Also, there has been the stimulus of reform legislation, as previously mentioned, particularly the Chief Financial Officers Act of 1990 and related legislation. I would point to the Results Act and the Clinger-Cohen Act also as having had a profound influence on DOD financial management. But it is an enormous challenge.

As Mr. Lynn said, DOD had somewhat over 300 finance and accounting systems in place when the CFO Act was passed, and none of them were capable of producing the kind of data needed to meet modern accounting standards. Also, there was no particular audit requirement related to financial reporting by the DOD, which in retrospect seems somewhat amazing, but was very true at the time.

The DOD efforts to compile and audit the annual financial statements for the Department as a whole and for its nine subsidiary reporting entities have been massive, year after year, for 10 years. Unfortunately, the Department has never been able to overcome the impediments caused by poor systems and inadequate documentation of transactions and assets.

In terms of opinions, the audit results again this year differ little from those of the past several years. A clean opinion was possible for the military retirement fund, but we had to disclaim the ability to render an opinion on any of the other reporting entities or on the Department's statements as a whole. In accounting terms, that means that the statements were unauditable.

The scope of accounting adjustments to financial statements is perhaps one of the best indicators of how hard it has been for DOD to follow private sector financial reporting practices. When the financial reporting system of a corporation can't generate fully reliable financial statements, accountants sometimes make accounting entries, often as recommended by their external auditors, to complete or correct the statements. But making major entries or adjustments to override, correct or transfer data is not the preferred way of doing business; and there is considerable attention paid to any significant change to official accounting records before the contents of those records are disclosed in financial statements.

The notion of accounting entries being made on a massive scale, in most cases to compensate for underlying system problems, is completely foreign to Corporate America, as is the prospect of any such adjustments being unsupported by clear audit trails. In fact, accounting adjustments are closely scrutinized by external auditors and the Security and Exchange Commission for fraud indicators.

Unfortunately, the Defense Department has no integrated systems for compiling financial statements and relies on the patchwork of crosswalks, workarounds and what in the Army years ago we used to euphemistically call "field expedients."

The audits of the fiscal year 1999 DOD financial statements indicated that thousands of accounting entries worth \$7.6 trillion were made to compile them. Of the \$5.8 trillion worth of those adjustments that we audited this year, \$2.3 trillion were unsupported by reliable explanatory information and audit trails or were made to invalid general ledger accounts.

These huge amounts portray a massive, but fundamentally inefficient and largely futile, attempt to get the numbers right on the financial statements. We now clearly have the Department's attention in this particular problem; and, actually, we are pleased with recently announced initiatives to minimize unsupported changes. But, fundamentally, the number of adjustments is not going to come down appreciably until new and better systems are in place. CFO Act compliance is fundamentally a systems problem.

The testimony of the other witnesses today provide good summaries of the other major deficiencies in the statements. So in my written statement I discuss just two examples of areas where I believe the rigor of better financial control would help the Department address persistent problems. Those are inventory and environmental cleanup. I would be happy to address any questions you have in either of those areas.

It is particularly important, however, this morning to stress our concern about the long-standing lack of good ways to measure progress toward sound financial reporting and to focus on the long poles of the tent, which are the noncompliant systems.

Audit opinions on the annual agency financial statements still are the only widely used way of measuring progress by the Federal Government toward accurate and, by implication, useful financial reporting. Unfortunately, this means that considerable improvement can be made within each of the huge DOD reporting entities without any appreciable effect on the overall audit opinion. A series of declarations that the statements are unreliable or unauditable tells you very little about what progress has been made and what remains to be done, especially in terms of replacing or fixing specific systems. Conversely, a favorable audit opinion can be misleading, too. We fully agree with the GAO that a clean audit opinion would not necessarily be synonymous with responsive financial information that enables sound decisionmaking.

First, auditors can easily determine for you the accuracy of the numbers, but usefulness is more of a moving target. I don't think there has been enough dialogue between the Congress and the executive branch about what information in these financial statements would be useful.

Secondly, audit opinions can be gamed. If the financial statements are put together using ad hoc procedures for bypassing the official financial systems and records that are relied on for day-to-day management information, the clean audit opinion can actually mask continued underlying serious problems with systems, records and actual operations. Therefore, I urge that the limitations of audit opinions per se be kept in mind as we assess DOD's performance.

To help develop CFO Act compliance performance measures and to enhance management control, last year we recommended that DOD apply its highly successful Y2K management approach to the challenge of attaining CFO Act compliance. As was the case with the Y2K conversion, the CFO Act challenge is fundamentally a systems problem, which needs to be addressed with a clear, widely distributed plan that draws in all parts of the Department, not just the financial community. This is a problem that requires cooperation and resource expenditure by every single part of the Department—the acquisition people, the personnel people, the logistics people and what have you.

There are several advantages to using the kind of individual system measurement terminology that we used for Y2K. The Department knows this approach works, managers and the Congress are familiar with the terminology, and it entails fairly simple and verifiable metrics to show progress in highlight risk areas.

We are pleased that the Department has adopted this recommendation and concept, but, frankly, the implementation has been disappointingly slow—

Chairman SHAYS. Let me give you about a minute more.

Mr. LIEBERMAN [continuing]. Yes, sir. I will finish in that time. And key Y2K process attributes are still missing.

Similarly, the biennial financial management improvement plan still has holes in it. For example, although we have a fairly well-defined goal for when finance and accounting systems are going to be compliant, that is 2003, we do not have a sound, definitive goal for when all the feeder systems are going to be compliant. As Mr. Lynn said, they are absolutely critical.

In closing, I would like to mention that in DOD we have a cooperative effort, a good relationship between the audit and finance communities. We have written lots of candid audit reports for 10 years taking the Department to task on these matters, and the Department in general has tried very hard to be responsive. This is, though, a massive task; and we think it is going to be several more years before you can look forward to clean audit opinions on the Department of Defense.

Thank you, Mr. Chairman.

Chairman SHAYS. Thank you, Mr. Lieberman.

[The prepared statement of Robert J. Lieberman follows:]

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

Mr. Chairman and members of the Task Force, I am pleased to have the opportunity today to discuss the efforts of the Department of Defense 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.

I would like to begin by underscoring both the critical importance of sound financial management and the unavoidable complexity of finance and accounting operations in an organization as large as the DOD. It is useful to keep in mind that the Department is the largest holder of U.S. Government physical assets (\$1 trillion), has the most employees (about 1,500,000 active military and 710,000 civilians), owns the most automated systems, administers the most complicated chart of accounts, and manages the most diverse mix of operating and business functions of any Government Agency.

The average monthly finance and accounting workload includes cutting 5 million paychecks, taking 920,000 contract or purchase actions and reporting commitments, obligations, expenditures and other data for many thousands of accounts.

PAST PRACTICES AND RESULTING CHALLENGES

The Department's accounting systems and financial reporting practices mirrored its overall management philosophy during the 1950's through 1980's. Most DOD business processes—acquisition, inventory management, maintenance, training, and many others were decentralized; controlled in theory by elaborately detailed rules and regulations; developed unilaterally by organizations operating within their own functional “stovepipe” with insufficient coordination with other stakeholders; and often labor intensive despite the use of many thousands of automated systems.

In the finance and accounting area, each Military Department operated dozens of systems; data element standardization was never effectively enforced; DOD accounting policies were enunciated in a Handbook whose precepts were not mandatory and therefore were widely ignored; and the primary focus of financial reporting was on funds control, not on providing the full range of financial data needed by managers. In retrospect, it is remarkable how infrequently the DOD accounting community was asked questions along the lines of how much does it cost to run a base, fill a requisition or operate a warehouse. To this day, when such cost information is needed, managers frequently must hire consultants to make estimates or use special data calls instead of relying on standard reports, often with questionably reliable results.

During the 1990's, a combination of factors highlighted many longstanding DOD financial management problems and created new challenges for DOD. Those factors included:

- The centralization of most DOD finance and accounting functions into the Defense Finance and Accounting Service (DFAS) in 1991 was a long overdue initiative to streamline the organizational structure in this area. Establishing a central organization is never easy, because users and customers are leery about the quality of service they will receive from offices they no longer directly control and some elements of the workforce resist change. In the case of DFAS, the usual problems were compounded by the compelling need to make deep workforce cuts rapidly and close many finance offices, as DOD sought to reduce its support costs. The downsizing effort was a major preoccupation for the first several years of DFAS' existence. In addition, DFAS was created at the same time the Department was expanding its revolving fund concepts to require users of services to pay for the total costs of those services. DFAS soon became immersed in arguments with customers over fees for services that previously had appeared free or cheaper from the users' standpoints. Some users continue to regard DFAS as a monopoly with inadequate incentives for cost reduction or service quality improvements.

- The Chief Financial Officers (CFO) Act of 1990 required preparation and audit of financial statements of revolving funds, trust funds and commercial-like functions throughout the Federal Government. Additionally, the Departments of the Army and Air Force were designated as pilot programs, requiring preparation and audit of financial statements for the General Funds of those Services. The Federal Financial Management Act of 1994 expanded the requirement for annual audited financial statements to all DOD funds, as well as Government-wide financial statements. The DOD and many other Government agencies lacked the systems, controls and policies for complying with those requirements.

- The Federal Financial Management Improvement Act of 1996 requires the head of each Federal agency to prepare a Remediation Plan if the agency's financial management systems do not comply substantially with Federal accounting standards, requirements for financial management systems, and the U.S. Government Standard General Ledger at the transaction level. The Department's systems cannot meet any of those standards and therefore the DOD is implementing a Remediation Plan.

- The National Defense Authorization Act of 1998 requires the Secretary of Defense to submit to Congress a biennial strategic plan for the improvement of financial management within DOD. The Biennial Plan is to address all aspects of finan-

cial management, including the finance systems, accounting systems, and data feeder systems that support financial functions. The Authorization Act also included additional detailed requirements for a statement of objectives, performance measures, schedules, and the identification of individual and organizational responsibilities for Special Interest Items. Because of other, similar reporting requirements, the Department now considers this to be an annual report.

- Previous Government accounting and auditing standards were inadequate for CFO Act implementation and private sector financial reporting methods cannot be adopted by the public sector without considerable modification. Therefore, over the past few years, the Federal Accounting Standards Advisory Board (FASAB) has issued 18 new accounting standards and 3 concepts. Each of these standards has generated very significant new workload requirements for the DOD managers who are trying to make systems "CFO compliant," for the preparers of financial statements, and for the auditors. The standards also require further clarification and interpretation, as with any new set of policies.

- Because of its size, the DOD is required to prepare financial statements for both the overall Department and for numerous large component entities, such as each Military Department's General Fund. No other Federal Agency has an equivalent accounting and auditing workload. The annual financial audits alone consume about 400 staff workyears of my office and the Military Department audit organizations. The full cost of DOD CFO Act compliance effort has never been identified.

FINANCIAL STATEMENT AUDIT RESULTS

Neither the full integration of DOD support operations, including financial management, nor the achievement of clean audit opinions on the consolidated DOD financial statements are feasible short term goals. The Department remains several years away from being able to achieve favorable audit opinions on most major financial statements, although breakthroughs on a few individual statements are likely over the next couple years.

The DOD efforts to compile and audit the FY 1999 financial statements, for the Department as a whole and for the 9 subsidiary reporting entities, 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 past several years. 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 scope of accounting adjustments to financial statements is one of the best indicators of how difficult it has been for DOD to emulate private sector financial reporting practices. 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 to override, correct or transfer data 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, in most cases to compensate for underlying system problems, is completely foreign to Corporate America, as is the prospect of any such adjustments being unsupported by clear audit trails. In fact, accounting adjustments are closely scrutinized for fraud indicators.

The audits of the FY 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 or were made to invalid general ledger accounts. About \$602.7 billion of accounting entries were made to correct errors in feeder reports.

I will discuss some of the other specific problems in the statements later in this testimony, but first I would like to mention our longstanding concern about measuring where the DOD CFO Act compliance effort stands.

MEASURING PROGRESS

Audit opinions on the annual agency financial statements still are the sole widely used metric for quantifying progress by the Federal Government toward accurate and, by implication, useful financial reporting. Unfortunately, this means that considerable improvement can be made in each of the huge DOD reporting entities without any effect at all 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), which is a key part of the Air Force General Fund financial statements. Notwithstanding these numerous improvements and corrections, the effort could not overcome the problem of an unreliable opening balance. Despite a relatively near miss, the Air Force SBR audit result for FY 1999 is scored as another failure for the Department, one of many disclaimed audit opinions, but this is only part of the story.

Although the DOD deserves credit for the considerable effort made to improve its financial reporting, it seems that everyone involved—the Congress, the Office of Management and Budget, the audit community and DOD managers—have at best a general sense of 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, as previously mentioned, 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. What has been in place up until now has been a 1970's or 80's management model.

APPLYING YEAR 2000 LESSONS LEARNED

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 and it is fundamentally a systems problem. Therefore it can be addressed most effectively if there are goals, criteria and milestones set forth in a clear management plan that involves all DOD organizations and functional communities, because it cannot be overcome unilaterally by the Chief Financial Officer without the active assistance of the rest of the Department. Like Y2K compliance, CFO Act compliance needs 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 and the Congress 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 and key Y2K process attributes are still missing. 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, but we understand this milestone has slipped until later this year. 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. This is in marked contrast to the Y2K conversion effort, which we supported on a massive scale and whose managers shared status reporting with the auditors on a virtually continuous basis. To help redress this weakness, we plan to issue at least one report this year on the Assessment Phase, based on a self-initiated audit.

The Biennial Plan did not identify an overall milestone to correct all system deficiencies and fully integrate the financial management systems. The Plan stated that compliant finance and accounting systems are expected to be in place by FY 2003, which likely is optimistic. Significantly, the Plan did not provide a specific date goal for correction of all feeder system deficiencies. Because the logistics, personnel, acquisition and other feeder systems provide from 50 to 80 percent of all data, this is a crucial gap in last year's plan.

We have identified feeder systems with intermediate target dates extended beyond the FY 2003 milestone for the finance and accounting systems. For example,

the Army Standard Installation and Division Personnel System had a September 2005 milestone for improvements. It is important that there be a clear understanding of the plan for those feeder systems and intensive management of this vital segment of the overall effort. We will work with the Department this summer to strengthen management oversight and the next iteration of the plan. We consider it crucial that the Department act now to be able to provide the incoming Administration with a clear and realistic roadmap of what needs to be done to attain a new generation of fully capable systems and clean audit opinions on the output of those 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, as previously discussed, handicap an assessment of whether the effort to attain auditable financial statements has been worthwhile. The more important question to be asked, however, is whether data produced in compliance with Federal Accounting Standards and validated 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, frequently often during the year, the focus should be across the spectrum of financial information reported within and by the Department, in whatever form.

We fully agree with the General Accounting Office that a clean audit opinion would not necessarily be synonymous with responsive financial information that enables sound decision making by program officials and resource allocators. This would be particularly true if the financial statements were formulated using ad hoc procedures for bypassing the official financial systems and records that are relied on for day to day management information.

Questions on the usefulness of various financial reports can best be answered by the users, not auditors or accountants. 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.

ASSET ACCOUNTABILITY

Accounting and auditing standards can be very arcane. In my view, some of the property valuation issues confronting the Department are marginally relevant in Government and will never have any impact on DOD decision making. However, other management information deficiencies identified by the financial statement audits have very practical implications. For example, inventory management has been a high risk area for DOD for many years. Having complete, accurate and timely data on inventory is essential for logistics readiness and for making good procurement and disposal decisions.

Examples of inventory accuracy problems were highlighted in our report on Inventory Accuracy at the Defense Depot, Columbus, Ohio, February 27, 1997, and a follow-up report on Assuring Condition and Inventory Accountability of Chemical Protective Suits, February 25, 2000. For the first audit, we observed an inventory count of chemical protective suits, which must be carefully controlled as a critical warfighting item. The audit disclosed major discrepancies between the Columbus Depot's records and the actual number of chemical protective suits on-hand. The audit indicated 423,062 fewer protective suits actually on-hand than in the records. At other locations on the premises that were not designated as containing protective suits, we found an additional 696,380 protective suits that were not on the inventory records. This loss of control was caused by poor management practices, rather than by problems with the automated inventory records system. Management took action to regain control of the chemical protective suits and temporarily corrected its records. Shortly thereafter, as part of efforts to consolidate overall supply depot operations, the protective suits were transferred to the Defense Depot at Albany, Georgia.

Last year, we observed the physical inventory count for 158 items stored at the Defense Depot, Albany. One of the sampled items was one of the types of protective suits that we had addressed in 1997. We discovered that, instead of improving inventory management, the transfer of the protective suits had had the opposite effect. The inventory records were again materially inaccurate. Although the records indicated 225,202 protective suits on hand, the physical count was 31,277 less. We also reported that these suits had been involved in a criminal investigation by the

Defense Criminal Investigative Service, were potentially defective, and should have been withdrawn from active inventory. This problem was not caused by the inventory record errors, but does illustrate that financial audits can have a variety of benefits and highlight problems other than poor accounting. The inventory records have again been corrected and the potentially defective suits have been designated as usable for training only.

FINANCIAL LIABILITIES FOR ENVIRONMENTAL CLEANUP

Another area where DOD financial statements have been materially deficient, and which involves controversy about the practicality of the new accounting standards, is the recognition of liabilities for environmental costs to dispose of equipment and clean up DOD installations. 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 is, 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 issues regarding when to recognize environmental disposal costs for other than nuclear powered weapon systems on financial statements. Also, the cost estimates for installation cleanup need improvement.

For example, the \$20.7 billion equipment disposal portion of the 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.

An open issue remains on when to recognize environmental 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 of what the accounting standards require and how much flexibility the DOD has to distinguish between nuclear powered systems and others with different types of hazardous materials. 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. Recent 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. Both Congress and DOD have stressed the importance of complete life cycle cost estimates for weapon systems, and stated that support costs are the most frequently understated category. Disposal costs are part of support costs.

The DOD reported \$34 billion as the liability for environmental cleanup of munitions residue 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 and some managers question the usefulness of collecting the data. Although final DOD guidance for reporting liabilities for cleanup of training ranges has not yet been published, it is expected in FY 2000. Also, we will issue a report next month on inefficiencies in the processes for collecting and disposing of range residue.

SIMPLIFYING ACCOUNTING 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. This multiplicity of "colors of money" is a root cause of the formidable DOD problems with the accuracy of accounting data, the complexity of contracts, the difficulty of properly managing disbursements and progress payments, the high overhead costs of DOD budget and accounting operations, and the considerable restrictions on the flexibility of managers to shift funds quickly to meet contingencies. Millions of docu-

ments must contain at least one, and in some cases, many accounting classification codes that typically have from 46 to 55 characters each. Compare 12 or 16 characters used for a commercial credit card to a typical Navy fund cite:

17x1611 1936 026 54002 3 068572 ID 000151 000560852000

We believe that the DOD and Congress ought to reconsider the need for so many discrete appropriations, budget activities, line items, and other subaccounts. These kinds of issues are seldom considered in the context of management reform, but we believe that any streamlining of DOD accounting requirements would considerably assist managers in avoiding errors, improving data quality, and cutting overhead costs throughout the Department.

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. A single appropriation may have many hundred subaccounts. 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 levels of detail.

OTHER CONCERNS

We have concerns about information assurance, fraud and management controls in 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. Conflicting priorities and constrained resources have minimized recent audit coverage of vendor pay and other high risk areas related to financial management. Nevertheless, the results of the relatively few audits performed recently on other than financial statement processes provide an insight into what kinds of issues require management attention. For example:

- Last November we reported that the Department's policies on the timely recording of fiscal obligations needed to be strengthened to ensure compliance with the intent of applicable laws. The Department has taken responsive actions.

- On June 5, 2000, we reported that DFAS had improved controls over vendor payments made for the Air Force using the Integrated Accounts Payable System, but more needed to be done to ensure that all payments were properly documented for compliance with the Prompt Payment Act. About 176,000 of 307,000 payments made from April through June 1999 lacked complete supporting documentation. Although we found no indication of widespread fraud, better compliance with prescribed controls would diminish the risk of fraud and non compliance with laws such as the Prompt Payment Act.

- On June 9, 2000, we reported that management controls over the National Drug Control Program funds received by DOD were reasonable; however, the manual process used to report the status of those funds to the Office of National Drug Control Policy was not linked to the official accounting records. As a result, we were unable to attest to the accuracy of the annual report for FY 1999 as required by Public Law 105-277, the Office of National Drug Control Policy Reauthorization Act of 1998. This is a good example of the current inability of DOD accounting systems to provide information needed by the DOD and Congress, necessitating special workaround measures.

- On June 16, 2000, we reported that the DOD had not rigorously applied the principles set forth in the Clinger-Cohen Act when approving the acquisition strategy for the Defense Joint Accounting System. The planning for this new system, currently intended to be one of four DOD systems for multi-organization general fund accounting, has been severely criticized by the House Armed Services and Appropriations Committees. The main concerns are the lack of a sound analysis of alternatives and the poor precedent involved in the combined Milestone I and II approval for the project despite the absence of that analysis.

- On June 29, 2000, we reported that controls needed improvement to ensure that payroll withholding for DOD civilians was accurate. A limited sample of withholding in 279 individual accounts indicated errors in 24 accounts and inadequate supporting records in DOD personnel offices. This is an example of a payment problem that is caused by erroneous input from feeder systems, not by errors in the finance office, but the tendency is to blame DFAS.

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 and we urge the Task Force to continue its dialogue with the Department on these tough issues. Despite commend-

able progress, the DOD remains far from CFO Act compliance and continued measures will be needed over the next several years to achieve success. The DOD audit community, which has invested so much effort and resources in this area over the past several years, very much appreciates your interest in our activities and viewpoints. The titles of some of our reports that are applicable to this testimony are attached, for ready reference.

Finally, I would be remiss if I did not mention that the DOD audit community has an outstanding relationship with the Department's financial managers and virtually all of our recommendations have been accepted over the past several years. Likewise, the advice of the General Accounting Office has been very helpful to us and we will continue working closely with them to provide DOD and Congress with a well rounded picture of DOD financial management issues. This concludes my statement.

EXAMPLES OF FY 2000 INSPECTOR GENERAL, DOD, REPORTS AND TESTIMONY RELATED TO THIS STATEMENT

- No. 2000-030, Recording Obligations in Official Accounting Records, 11/4/99
- No. 2000-041, Deficiencies in FY 1998 DOD Financial Statements and Progress Toward Improved Financial reporting, 11/26/99
- No. 2000-069, FY 1998 Department of Defense Agency-Wide Statement of Budgetary Resources, 12/29/99
- No. 2000-077, Testimony by Deputy Inspector General, DOD, to the House Budget Committee on Defense Management Challenges, 2/17/00
- No. 2000-086, Assuring Condition and Inventory Accountability of Chemical Protective Suits, 2/25/00
- No. 2000-091, Internal Controls and Compliance with Laws and regulations for the DOD Agency-wide Financial Statements for FY 1999, 2/25/00
- No. 2000-120, Testimony by Assistant Inspector General for Auditing, DOD, to Subcommittee on Government Management, Information and Technology, House Committee on Government Reform 5/7/00
- No. 2000-121, Hazardous Material Management for Major Defense Systems, 5/4/00
- No. 2000-136, Reporting of Performance Measures in the DOD Agency-Wide Financial Statements, 5/31/00
- No. 2000-139, Controls Over the Integrated Accounts Payable System, 6/5/00
- No. 2000-151, Acquisition of the Defense Joint Accounting System, 6/16/00
- No. 2000-156, DOD Payroll Withholding Data for FY 1999, 6/29/00

All reports and testimony listed above are available on the Internet at www.dodig.mil.

Chairman SHAYS. Mr. Steinhoff.

STATEMENT OF JEFFREY C. STEINHOFF, ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. STEINHOFF. Mr. Chairman, members of the Task Force, a pleasure to be here today.

Mr. Chairman, as you said in your opening, DOD has an incredibly vast and complex worldwide mission that it carries on in a way that no other nation can match. Financial management must play an important role in carrying out that mission. The bottom line, DOD continues to make important progress in addressing its serious financial management weaknesses, as the other witnesses have said. 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. My testimony today highlights some of the challenges DOD faces.

As we have reported in the past, these weaknesses adversely impact on DOD's ability to control cost, to ensure accountability and to address pressing management issues which drain resources needed to carry out missions and to increase readiness. World-class organizations have found, private sector and government, that there is a great payoff from good financial management and the

ability to efficiently and effectively manage day-to-day operations and to anticipate future costs and claims on the budget.

What has been markedly different in DOD over the last 2 years is we have seen for the first time a clear and demonstrated commitment to address these serious weaknesses. A number of important initiatives, both short and long term, are under way and planned; and we are seeing positive results. I applaud Bill Lynn and his top team for their efforts. As he mentioned before, they are facing systems and problems that go back decades and a culture that viewed these issues in a stovepiped manner and administrative versus viewing financial management at the fiber of managing.

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 the short term, continuing efforts to standardize, streamline and simplify processes, reengineering will be critical to success. I can't overemphasize that. They have to change the basic processes they have in place today.

Next, they have to strengthen and enforce existing controls. There is no lack of controls in Defense. In some areas there may be too many controls, but they oftentimes are not followed or enforced to ensure basic transaction processing which today is a major impediment as well as a cost that can be greatly reduced.

As you will see in my detailed statement, there are a tremendous amount of adjusting entries—one of every three disbursement transactions, \$51 billion last fiscal year was an adjustment. So they are entering transactions, and then reentering them to correct them. Some are corrected years later. This is a tremendous expense.

The private sector and successful State governments have found that the key to having good finance operations is to reduce your backroom operations. You don't want to be spending a whole lot of time processing and reprocessing transactions. Have them processed one time at the source. You have tremendous economies, tremendous savings, you have richer data, and the data comes to you on a day-to-day basis.

Next, they have to develop more reliable estimates of some of their future liabilities, which will be helpful in the budget process. They have to enhance human capital, and they have to oversee performance.

At the heart of the long-term challenge—and I echo the other witnesses' views; this is a long-term challenge—is a financial system that needs to be overhauled. The system is not integrated or tied together and represents a patchwork of systems that individually have weaknesses, some very serious, and collectively simply do not get the job done. Information does not automatically flow from system to system, as the IG reported.

To prepare its fiscal year '99 financial reports, DOD has had to make thousands and thousands of accounting entries and adjustments totalling \$7.6 trillion.

To give you some sense—this isn't the whole picture. This is some sense of the challenge that Bill Lynn and his folks face. Over at your left is an example of DOD's own depiction of the current system's environment for its payment system. They have got other systems and other operations; and, as you can see, this is overly

complex. The system has been built up over decades. Around the outer edge are 22 payment systems that are fed by numerous other systems, systems that are generally not compatible or properly tied together and often do not use common data codes. In a nutshell, this tells a story as to what they are trying to fix.

Compounding the challenge is that most of the information needed to prepare annual financial reports and, more importantly—I want to emphasize more importantly—to manage DOD's operations on a day-to-day basis comes from feeder systems—logistics, acquisition, personnel—that are not under the comptroller's control. He controls around 20 percent of the information. The other 80 percent comes in from the other systems.

So to achieve the end game of the CFO Act, and that end game is systems that routinely provide reliable, useful, timely information for day-to-day management purposes, DOD faces a systems challenge that transcends the comptroller's operation. It is far beyond financial reporting, and it is at the fiber of the management system in DOD.

The Y2K experience I think can be a great teacher. DOD lagged far behind on Y2K on a regular basis. Steve Horn was grading the Department as an F. But the Department recognized that fundamental changes had to be made. They successfully turned the Y2K effort around, and they passed that test with flying colors. They demonstrated that applying some of these concepts can get them to that finish line.

First, DOD recognized that Y2K was a chief executive officer issue, not just a CIO issue. The Department Secretary took direct control, exerted strong overall leadership over Y2K.

DOD's financial management challenge cuts across its operations similar to Y2K. It also has a host of initiatives ongoing in logistics and in the other functional areas to deal with systems; and given DOD's corporate culture, which tends to be stovepiped within services, tends within activities to be stovepiped, having a strong, direct, sustained leadership must come from the top. It must be at the corporate level, at the deputy level.

I brought some copies today of our executive guide—Creating Value Through World-Class Financial Management, which was just issued back in April. In performing this study we went to Boeing, Chase Manhattan, GE, Hewlett-Packard, Owens-Corning, Pfizer, and the States of Massachusetts, Texas and Virginia. We found in successful organizations, private sector and government, that financial management is an entity-wide priority for which the chief executive provides clear, strong leadership, including being actively engaged in systems development. They see this as the lifeblood of the company.

Second, Y2K had a date certain. Financial management reform doesn't have the same type of date certain, but Y2K also had interim dates that you had to meet along the way to gauge the likelihood of meeting the January 1st date. And it also had periodic self-reporting.

It gets back to what Mr. Lieberman said, have interim steps, have interim goals. Next year this time, probably DOD will not have a clean audit opinion again. I think you can expect that, but establishing interim goals, measuring DOD against how it is meet-

ing those interim goals, and having the rigor of reporting back against those goals will be very important.

Third, for Y2K, DOD followed a structured, disciplined approach. Given the tremendous complexity of this challenge, it will be very important that DOD fully adhere to the investment controls in the Clinger-Cohen Act.

There have been other systems initiatives in DOD. They have been extremely problematic. Systems development—and I am talking about information technology systems—has been a GAO high-risk area since 1995. So they have a track record where developing systems has been difficult. Many other agencies are in the same boat, and the private sector, has problems as well. So a disciplined approach will be very important.

Also, for Y2K, the IG was very much involved with validation, with interim reporting, with working with DOD on a real-time basis; and that kind of partnership will be important.

In closing, the comptroller and his staff should be applauded for their efforts. They have a long way to go, a sustained, high-level commitment that transcends this administration. This is a multiyear effort and will be key to the ultimate success of DOD's reform efforts. Likewise, sustained congressional attention such as this hearing and the work of this group will be crucial to instilling the expected accountability in DOD.

Mr. Chairman, members of the Task Force, this completes my summary remarks. I will be pleased to respond to any questions at this time.

Chairman SHAYS. Thank you.

[The prepared statement of Jeffrey C. Steinhoff follows:]

PREPARED STATEMENT OF JEFFREY C. STEINHOFF, ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GOVERNMENT ACCOUNTING OFFICE

Mr. Chairman and members of the Task Force, I appreciate the opportunity to discuss financial management issues at the Department of Defense (DOD) and their implications for the budget process. We recently testified¹ before the House Subcommittee on Government Management, Information and Technology on the status of DOD's efforts to address its long-standing pervasive weaknesses in financial management systems, operations, and controls. 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. Unreliable cost and budget information affects DOD's ability to effectively measure performance, reduce costs, and maintain adequate funds control, while ineffective asset accountability and control adversely affect DOD's visibility over weapons systems and inventory.

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 address the department's serious financial management problems. At the same

time, DOD has a long way to go. Major problems remain—problems that are pervasive, long-standing, deeply rooted, and complex in nature. Our previous testimony outlined DOD's most difficult financial management challenges and described the many initiatives that are under way or planned to address them.

Today, I will highlight certain of those ongoing challenges, with a focus on those that affect the reliability of budget execution data as well as other areas where accurate and complete financial management information could provide a useful perspective to decisionmakers related to budget requests, performance measures, costs, and other key decision points.

Finally, I will discuss DOD's plans and actions to develop an integrated financial management system that complies with Federal system standards. To achieve what the Comptroller General has referred to as the "end game"—systems and processes that routinely generate good financial information for day-to-day management purposes—will require a major systems and reengineering effort. Integrated financial management systems, along with marshaling the human capital needed to achieve results, have long been cited as major components to the final resolution of DOD's financial management problems. The successful Year 2000 effort demonstrated that DOD can resolve complex, entitywide problems through top management leadership working across functional lines. Applying the Year 2000 lessons learned to the department's financial management system integration effort will require similar leadership and commitment to a disciplined systems development approach.

RELIABILITY OF BUDGET EXECUTION DATA IMPAIRED

As an integral part of an effective budget execution system, an agency is responsible for determining and maintaining its available fund balance. Treasury also has information about activity in the agency's accounts, and Treasury's and the agency's records must be periodically reconciled to determine the actual amount of funds available. This is analogous to reconciling one's personal checking account with the monthly bank statement. DOD weaknesses in accounting for its funds include (1) the inability to reconcile its balances to Treasury's, (2) frequent adjustments of recorded payments from one appropriation to another appropriation account, including to canceled appropriations, (3) problem disbursements—disbursements that are not properly matched to specific obligations recorded in the department's records, and (4) obligated balances that are incorrect or unsupported.

As a result of these weaknesses, auditors have been unable to verify DOD's Fund Balance With Treasury and its major components—obligated and unobligated balances. This means that DOD does not know with certainty the amount of funding that is available. This information is essential for DOD and the Congress to be able to determine the status of funds and if unobligated balances are available that could be used to reduce current funding requirements or that could be reprogrammed to meet other critical program needs.

SIGNIFICANT DIFFERENCES BETWEEN DOD'S AND TREASURY'S RECORDS

Although DOD has made some improvements in its accountability over its fund balance with Treasury, the amount of funds available at DOD remains questionable because (1) significant differences between DOD's and Treasury's records remain, (2) the reduction in differences between Treasury's and DOD's recorded fund balances may be, in part, a result of a change in policy rather than an actual reduction, and (3) items in suspense accounts, which cannot be identified with a specific appropriation account, may not be DOD transactions.

DOD made the reduction of differences a high priority in its short-term improvement plans last year. There was a drop in the amount of the unresolved differences from \$9.6 billion at September 30, 1998, to \$7.3 billion at September 30, 1999. Although some of the differences may be due to the timing of transaction processing at Treasury versus DOD, an aging of the difference suggests that significant reconciliation issues remain. For example, of the \$7.3 billion difference, \$2.5 billion is 60 days or older. Differences over 60 days old are generally not attributable to timing.

At least some of the decrease in the total differences as of September 30, 1999, can be attributed to the practice of some Defense Finance and Accounting Service (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, such as Treasury or DOD errors in recording transactions, have been addressed and resolved. For example, one Army disbursing station recorded \$608 million in differences to a suspense account.³ At year-end, DOD charged the differences to Army's

Operations and Maintenance appropriation, without documentation to support that these transactions should be recorded to this account. This resulted in financial reports to the Congress and OMB that show a reduction in the obligated balance in that account available for disbursement. However, DOD has little assurance that the charge should not have been properly assessed against, for example, some other Army appropriation or even to another entity's appropriation. Further, at the beginning of the next fiscal year, DOD reversed the Operations and Maintenance charges and returned the amounts to suspense accounts.

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. Until suspense account transactions are posted to the proper appropriation account, the department will have little assurance that appropriation balances are accurate, and that it has a right to any 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. To illustrate the magnitude of this issue, we previously testified⁴ that audit work for fiscal year 1997 found that while the Navy had a net balance of \$464 million in suspense accounts recorded in its records, the individual transactions—collections as well as disbursements—totaled about \$5.9 billion.

FREQUENT ADJUSTMENTS AFFECT RELIABILITY

DOD frequently adjusts recorded payments to transfer 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 specific appropriations. In March 2000, we reported⁵ 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. Adjustments were often made to original entries that were recorded years earlier. A number 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 Act⁶ and the bona fide needs rule⁷ to expired appropriations and to ensure that expired appropriations do not remain open on the government's books indefinitely.⁸

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.⁹ The decision concluded that Treasury may adjust the records of 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 the account before it closed.¹⁰

Adjusting disbursements previously recorded to current accounts by moving those transactions to canceled accounts can increase balances available for obligation in the current accounts. Since the 1991 account closing law was enacted, DOD has requested that Treasury reopen 333 closed accounts, totaling \$26 billion. These accounts remained open as of September 30, 1999. By comparison, all other Federal agencies combined have requested that Treasury reopen 21 closed accounts, totaling \$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. Chairman Kasich and Chairman Horn recently asked us to review DOD's practice of making adjustments to canceled accounts, and our work has just begun.

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 exam-

ple, 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 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 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 reported¹¹ \$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)¹² 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 raising an Antideficiency Act concern 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 if the appropriation is ultimately determined to be overobligated or overspent.

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 compliance with the Antideficiency Act, an agency's fund control system must record transactions as they occur. We and the DOD IG have previously reported¹³ on this issue and recommended that DOD revise its problem disbursement policies and procedures to ensure that accurate and reliable balances are maintained.

Finally, the process and control problems that result in the problem disbursement issues previously discussed also contribute to improper payments by the department. For example, our work continues to identify problems with overpayments and erroneous payments to contractors. For fiscal years 1994 through 1999, according to DFAS records, defense contractors returned over \$5.3 billion to the DFAS Columbus Center, including about \$670 million during fiscal year 1999, due to contract administration actions and payment processing errors. However, these amounts do not reflect the true magnitude of this problem because many overpayments are returned through billing offsets. We are currently working to estimate the scope of the overpayment problem, including these offsets.

OBLIGATED BALANCES WERE INCORRECT AND UNSUPPORTED

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

- The Army Audit Agency found¹⁴ that internal controls over the recording of obligations were not adequate to ensure that reported obligated balances were accurate. In a sample of 60 1999 transactions, the auditors found that 21 could not be supported.

- For fiscal year 1999, audit results¹⁵ show that the Air Force Working Capital Fund had \$211 million of obligations out of approximately \$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, 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.¹⁶ 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.

Accurate and reliable information would permit the Congress to review DOD year-end unobligated and unexpended balances and identify opportunities for possible funding reductions. For example, as a result of our analysis of unobligated balances in the military personnel appropriation, the House Appropriations Committee recommended a reduction of \$96 million in the fiscal year 2001 request for this account. Since the military services' account data have shown a pattern of not spending all of their appropriated funds, the Committee concluded that the fiscal year 2001 military personnel budget request is overstated and can be reduced.

IMPROVED DATA ON ENVIRONMENTAL/DISPOSAL LIABILITY WOULD BE AN IMPORTANT OVERSIGHT TOOL

Under federal, state, and international law, DOD faces a major funding requirement associated with environmental cleanup and disposal. These environmental costs result from the production of weapons systems and prior and current operations. Even when current operations are carried out in full compliance with existing environmental regulations, future cleanup costs for certain operations will still result due to the nature of these DOD activities. DOD has taken important steps to implement the Federal accounting standards¹⁷ requiring recognition and reporting of these liabilities and has made noteworthy progress. For example, DOD's reported estimated liabilities increased from \$34 billion in its fiscal year 1998 financial statements to \$80 billion in fiscal year 1999. However, the full magnitude and timing of these costs are not yet known because (1) all potential liabilities were not considered in the reported estimates, (2) estimates were not based on the consistent application of assumptions and methodologies across the services, and (3) support for the basis of reported estimates continues to be inadequate.

A reliable estimate of DOD's environmental liability would be an important factor in determining the cost of its operations and specific programs and for resource planning. To effectively, efficiently, and economically manage DOD's programs, its managers and oversight officials need reliable cost information for the following key decision points.

Evaluating programs—Long-term liabilities that affect program costs must be accurately measured and considered in evaluating the status of programs. For example, the liability for disposal activity is part of the overall life-cycle cost of weapon systems and can contribute to the ongoing dialogue on funding comparable weapons. The National Defense Authorization Act for Fiscal Year 1995 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.¹⁸ In addition, the Senate Committee on Appropriations has required that DOD develop disposal cost estimates for munitions.¹⁹

Making current economic choices—DOD's decisions on whether to outsource specific functions require accurate and complete supporting cost data. Yet DOD, as well as other government agencies, has historically been unable to provide actual data on the costs associated with functions to be considered for outsourcing. For example, environmental and disposal costs must 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.

Resource planning—Reliable information on the full extent of the environmental liability that DOD faces under current law and the likely timing of funding requests would enable DOD and the Congress to make informed judgments about DOD's ability to carry out those requirements. As the Comptroller General recently testified²⁰ before the Senate Budget Committee, although we are currently enjoying a period of budget surplus, it does not signal the end of fiscal challenges. Long-term cost pressures from programs such as Social Security and Medicare will consume an ever-larger share of the economy and squeeze the resources available for other commitments and contingencies, such as Federal insurance programs and cleanup costs from Federal operations known to result in hazardous waste, including defense facilities and weapons systems. Accurate and complete information on the magnitude and timing of DOD's environmental liability would permit DOD and the Congress

to strategically plan for this long-term liability and set realistic priorities among the competing challenges that we will face in the future. Further, quantifying this enormous liability and providing a breakdown of the costs by the approximate time periods the disposal costs are expected to be incurred would add an important context for congressional and other decisionmakers on the timing of resource needs, including those that are more near-term. For example, we estimated²¹ that approximately \$1.6 billion of the \$5.6 billion estimate for the disposal of nuclear powered submarines was for submarines that are already decommissioned and awaiting disposal.

In summary, the most significant issues faced by the department in determining and verifying its environmental/disposal liability include incomplete estimates, inconsistent methodologies, and inadequate documentation.

Incomplete estimates—To date, DOD has focused on what it expects will be its most significant liabilities, those associated with nuclear weapons and training ranges. It has not yet considered the magnitude of costs associated with other weapon systems, conventional munitions, or its ongoing operations, although these costs may also be billions of dollars. For example, the department's costs to 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.

Also, the costs of cleaning up and disposing of assets used in ongoing operations may be significant. Significant environmental and disposal costs are required 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. This estimate excluded post-closure maintenance costs (such as monitoring) which are estimated to exceed \$200,000 annually over 30 years. 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.

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 completion date. However, we recently reported²² 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 costs such as labor, emergency preparedness, and program management.

Inconsistent methodologies and inadequate documentation—Each military service independently estimated its liabilities with, in some cases, significantly different results, and the lack of documentation hampered auditors' ability to verify the estimates. For example, although the Air Force reported twice as many aircraft as the Navy, it has not yet reported environmental and disposal liabilities for its aircraft. The Navy's financial statements included an initial estimate of \$331 million in fiscal year 1999 for its disposal of fixed- and rotary-wing aircraft. In addition, our limited analysis of DOD's first-time effort to develop complete cleanup cost estimates for training ranges, which we view as an important step forward, showed that the reported amount of \$34 billion was 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, Califor-

nia, would result in a cleanup cost estimate of approximately \$4 billion for that installation alone.

Further, DOD has had ongoing problems in adequately documenting its reported liability—an important control in ensuring its reliability. Last year, the DOD IG reported 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. Military service auditors continue to find that significant portions of the reported restoration liabilities lack adequate support for the basis of cost estimates. For example, the Army Audit Agency found that the Army lacked support for its estimates and attributed it to the fact that recent guidance on documentation requirements was not properly disseminated to project managers and others preparing project cost estimates.

BETTER ESTIMATES OF RETIREE HEALTH CARE BENEFITS COULD ASSIST DOD AND THE CONGRESS

DOD and the Congress are looking at numerous options to provide more—and more cost-effective—health care to military personnel upon their retirement. Currently, there are several pilot programs underway to test the feasibility of providing additional health care benefits to retirees over 65 years, including the Medicare Subvention demonstration and the TRICARE Senior Supplement project.²³ Congress is now considering expanding these pilot programs to cover greater numbers of retirees or extending the length of the trial periods. The Congress is also considering expanding coverage of certain benefits, such as for pharmaceuticals, to Medicare eligible retirees. Reliable financial and patient care data would enhance the ability of DOD and the Congress to consider medical care options.

DOD estimates that, based on its current benefit programs, the cost of providing future health care benefits for military retirees and their dependents will be \$196 billion;²⁴ however, we have previously testified²⁵ that this estimate is unreliable because DOD does not have accurate or complete cost and patient care information. DOD developed its estimate using an actuarial model that relies on historical information about the retiree population and the numbers, types, and costs of medical services provided to them. The model also uses economic, actuarial, and other assumptions, such as future interest rates and projected rate increases for medical costs.

Improvements to the underlying data or assumptions can significantly change the liability estimate. DOD has made meaningful progress in improving the processes and underlying data on which its liability is based. For example, when better and more complete data about DOD's population, medical care costs, and outpatient clinic usage were used in the model in fiscal year 1999, the revised estimate was lower by \$37.5 billion, or nearly 17 percent, than the fiscal year 1998 estimate.

DOD has used its health care model to determine the long-term impacts of some benefit changes; for example, DOD recently calculated the long-term change in the liability of a proposal to provide eligibility for purchased care to retirees over 65. With better underlying data and some refinements to its methodology, DOD's model could be a valuable tool to both the department and the Congress for estimating the short-term, as well as long-term, budgetary impacts of complex changes to the retiree health benefits program. DOD has been using a similar model to calculate its long-term liability for military retiree pensions for many years, and both DOD and the Congressional Budget Office rely on the model to analyze the impact of changes to the retirement program.

As we testified in May 2000, DOD needs to improve the underlying data used by the model. First, DOD needs actual cost data for its military treatment facilities. DOD has been using budget obligation information as a surrogate; however, obligations do not reflect the full cost of providing health care because they do not, for example, include civilian employee retirement benefits that are paid directly out of the Civil Service Retirement and Disability Fund rather than by DOD. Nor do obligations include depreciation costs for medical facilities and equipment. In addition, DOD needs to improve the accessibility and reliability of its patient workload information. The DOD IG has reported²⁶ that medical services could not be validated either because the medical records were not available or outpatient visits were not adequately documented. The DOD IG also reported that outpatient visits are often double counted and that many telephone consultations have been incorrectly counted as visits. 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. DOD has been working with the audit community on health care cost and workload data deficiencies and currently has several improvement efforts underway. DOD has been using examples of blatant data errors, such as negative costs for some surgery

clinics and obstetric services provided to male patients, to stress to its own staff and to health care contractors the importance of its improvement efforts.

We are currently working with a contractor to assess DOD's retiree health benefits estimation methodology, and preliminary results indicate several areas where the model could be refined. DOD is currently assessing the feasibility and impact of making the following types of refinements.

- Pharmacy costs for retirees are currently not segregated from those of non-retirees, even though preliminary evidence suggests that retirees use more outpatient pharmacy resources. Also, the future trend rate used by DOD for pharmacy costs is the same as that for general medical costs, even though we previously estimated that DOD pharmacy costs increased 13 percent from 1995 through 1997 while its overall health care costs increased only 2 percent for the same period.²⁷
- In the past, DOD has assumed that numbers and types of clinic visits are adequate measures of outpatient health care usage for purposes of allocating health care costs to retiree and active duty populations; however, additional work may show that diagnosis related information is a better indicator of health resources usage because retirees may have more complicated diseases and therefore require longer and more resource intensive procedures.
- DOD's model currently does not calculate separate liabilities for retirees under and over 65 years old. DOD applies the same cost and economic assumptions to the two groups even though Medicare eligible retirees are offered different benefits than retirees under age 65 and therefore, their behavior, needs, and costs could be quite different.

CONTROL AND ACCOUNTABILITY FOR ASSETS IMPAIRED

DOD relies on various information systems to carry out its important stewardship responsibility over an estimated \$1 trillion in physical assets, ranging from multi-million dollar weapon systems to enormous inventories of ammunition, stockpile materials, and other military items. These systems are the primary source of information for (1) maintaining visibility over assets to meet military objectives and readiness goals and (2) financial reporting. However, these systems have material weaknesses that, in addition to hampering financial reporting, impair DOD's ability to maintain central visibility over its assets and prevent the purchase of assets already on hand. Overall, these weaknesses can seriously diminish the efficiency and economy of the military services' support operations. In addition, DOD's systems are not designed to capture the full cost of its assets, a major component in determining the total costs of its programs and activities. If reliable, such costs could be important tools for oversight and performance measurement.

Significant weaknesses in accountability and cost information for DOD's three major categories of assets include the following.

Weapons systems—The reported cost of this equipment in fiscal year 1997—the last year for which such information was reported on DOD's balance sheet—was more than \$600 billion. We have previously testified²⁸ that many of the military services' logistics information systems used to track and support weapon systems and support equipment were unable to be relied on. DOD continues to experience problems in accumulating and reporting accurate information on its national defense equipment.

For example, because the military 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. Items identified as a result of the fiscal year 1999 data call that were not included in the Army's centralized systems included 56 airplanes, 32 tanks, and 36 Javelin command-launch units. In addition, the military 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, property managers 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.

Because of the recognized problems with national defense asset information, 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.

In addition, DOD has 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 weapons systems. Accurate information on the life-cycle costs of weapon systems would allow DOD officials and the Congress to make more fully informed decisions about which weapons, or how many to buy.

Properly accounting for the revenue associated with the sale of these assets has also been a significant financial management challenge. 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 reported²⁹ 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
- could not explain differences between the recorded value of delivered goods and services and corresponding value of charges to customer accounts. (\$26.5 million or 19 transactions).

Inventory—DOD's inability to account for and control its huge investment in inventories effectively has been an area of major concern for many years. 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 reported³⁰ in our January 1999 high-risk report on defense inventory management that the department needs to avoid burdening its supply system with large inventories not needed to support current operations or war reserves. For example, our analysis of approximately \$63 billion of DOD's reported secondary inventory at September 30, 1999, showed that 58 percent of the reviewed items, or an estimated \$36.9 billion, exceeded these requirements. Further, during the fourth quarter of fiscal year 1999, only 2 of the Defense Logistics Agency's (DLA) 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's goal is 95 percent accuracy. 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.

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,³¹ 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 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.

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.

With regard to inventory cost information, Federal accounting standards require inventories to be valued based on historical costs or a method that approximates historical costs. However, 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. Inventory levels are also reported to the Congress 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 former Commander of Air Force Materiel Command testified in October 1999 that such valuation practices distort DOD's progress toward reducing inventory levels and impact Congressional funding decisions.³² The Commander stated the following.

"Part of the problem was accounting policy. * * * 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."

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.

Real and personal property—Audit tests of real property transactions, additions, deletions, and modifications that occurred during fiscal year 1999 indicated that DOD continues to lack the necessary systems and processes to ensure that its real property assets are promptly and properly recorded in its accountability databases. For example, Army auditors reviewed about \$408 million in real property 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.³³ In addition, recent audits by the military service auditors have continued to find that while DOD regulations require periodic physical inventories and inspections—a critical control in safeguarding assets—they are not always performed as required. Air Force auditors reported that real property personnel did not perform required inventories at 34 of 99 installations audited in fiscal year 1999. To illustrate the benefit of physical inventories, while implementing the Navy's new accountability system, the number of assets recorded in the accountability database at one Marine Corps location alone increased by over 35 percent as result of wall-to-wall inventories.

In addition, because DOD does not have the systems and processes in place to reliably accumulate costs, it is unable to account for several significant costs of its operations, including its facilities and equipment. Comprehensive and reliable asset financial information is necessary for determining the full cost of operations and can be useful for anticipating the need for additional budgetary resources.

An analysis of reported asset balances and related depreciation³⁴ can provide additional information to review specific budget requests. For example, the Navy reported that 85 percent, or approximately \$1.2 billion of its \$1.4 billion of depreciated equipment reported on its fiscal year 1998 financial statements, was fully depreciated. If Navy's financial information accurately reflected asset accountability and utilization periods, this information could be used as a factor in analyzing Navy's funding requests. Specifically, if the Navy's fiscal year 1998 information were accurate, it would indicate that most of the Navy's equipment is at or beyond its anticipated utilization period. This type of information could help support a funding request or, absent such a request, could be used to question whether operations would be impaired by the lack of needed capital equipment.

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.³⁵ DOD, which represents \$378 billion of the \$1.8 trillion, was not able to support its reported net costs. Although we have seen some improve-

ments in DOD's ability to produce reliable financial information, as noted throughout this testimony and discussed in greater detail in my May 9, 2000, 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 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 I will discuss later, this will require properly trained personnel, simplified processes, modern integrated 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. As I have highlighted today, the accuracy of the department's reported operating costs was affected by DOD's inability to

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

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.³⁶ 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 I stated earlier, DOD budget data are also unreliable.

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 reported last year on a long-standing concern over how accurately DOD's in-house cost estimates used in A-76 competitions reflect actual costs.³⁷

- 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. As noted previously, 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 reported³⁸ 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 they lack all the data needed to effectively manage their material costs.³⁹ As a result, DOD is unable to reliably assess the economy and efficiency of its business-like activities financed with working capital funds.

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 organizations⁴⁰ and to use the information technology investment criteria included in the Clinger-Cohen Act of 1996.

INTEGRATED FINANCIAL MANAGEMENT SYSTEM NEEDED

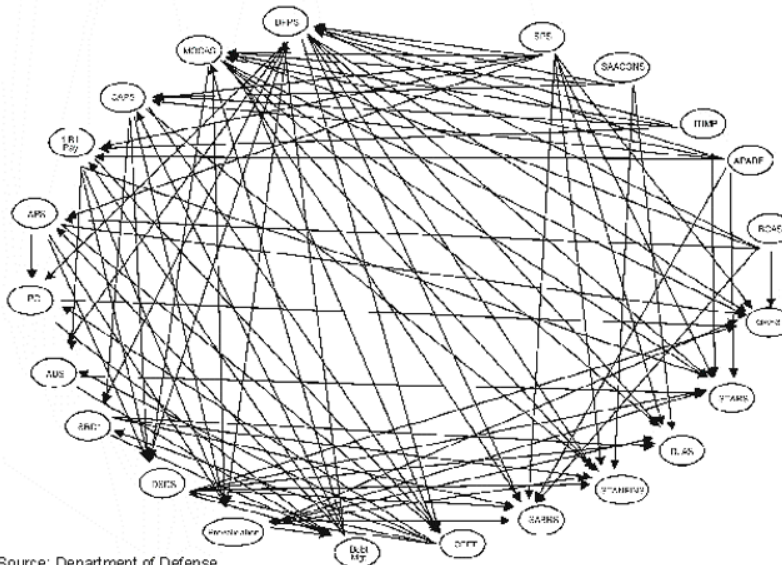
Establishing an integrated system is central to the framework for financial reforms set out by the Congress in the Chief Financial Officers (CFO) Act of 1990 and the Federal Financial Management Improvement Act (FFMIA) of 1996. Specifically, among the requirements of the CFO Act is that each agency CFO 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.⁴¹

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 reported⁴² 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 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.

DOD's Current 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 decision-makers and ensure greater control and accountability over the department's assets. However, we reported last year,⁴³ 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 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.

In its 1999 Financial Management Improvement Plan, dated September 1999, the department announced its intention 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)⁴⁴—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.

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.⁴⁵ 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.⁴⁶

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 Task Force may have at this time.

ENDNOTES

1. Department of Defense: Progress in Financial Management Reform (GAO/T-AIMD/NSIAD-00-163, May 9, 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).

3. A suspense account is a temporary holding account for problem transactions involving both collections and disbursements—for example, those rejected because of system edit controls.

4. Department of Defense: Status of Financial Management Weaknesses and Actions Needed to Correct Continuing Challenges (GAO/T-AIMD/NSIAD-99-171, May 4, 1999).

5. Financial Management: Differences in Army and Air Force Disbursing and Accounting Records (GAO/AIMD-00-2-, Mar. 7, 2000).

6. 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)).

7. 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.

8. 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. 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.

9. 72 Comp. Gen. at 343 (1993).

10. 72 Comp. Gen. at 347 (1993).

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

12. 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.

13. 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).

14. 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).

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

16. 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.

17. Statements of Federal Financial Accounting Standards No. 5, Accounting for Liabilities of the Federal Government and No. 6, Accounting for Property, Plant, and Equipment.

18. 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).

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

20. Budget Issues: Effective Oversight and Budget Discipline Are Essential-Even in a Time of Surplus (GAO/T-AIMD-00-73, Feb. 1, 2000).

21. The Department of the Navy reported an estimated disposal liability for all nuclear submarines, both active and inactive and awaiting disposal, of \$5.6 billion as of September 30, 1999. To determine the portion of the total reported \$5.6 billion liability that applied to inactive submarines awaiting disposal, we divided the \$5.6 billion by the total number of active and inactive submarines reported in the Naval Vessel Register to arrive at an estimated disposal cost per submarine of about \$49 million. Applying this average cost to the reported number of inactive submarines awaiting disposal, we estimated a cost of \$1.6 billion to dispose of decommissioned submarines awaiting disposal.

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

23. The Medicare Subvention demonstration allows retirees over 65 to use their Medicare benefit to receive care from DOD and Medicare will reimburse DOD for a portion of the cost of that care. The TRICARE Senior Supplement project allows older retirees to use TRICARE programs to supplement their Medicare coverage, including coverage of prescription drugs.

24. DOD's health benefits liability represents the present value cost of providing future health care benefits to current retirees and their dependents as well as to that segment of current active duty personnel and their dependents that DOD estimates will retire from the military. This estimate generally extends for the lifetimes or covered periods of eligible beneficiaries.

25. Department of Defense: Progress in Financial Management Reform (GAO/T-AIMD/NSIAD-00-163, May 9, 2000).

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

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

28. DOD Financial Management: More Reliable Information Key to Assuring Accountability and Managing Defense Operations More Efficiently (GAO/T-AIMD/NSIAD-99-145, Apr. 14, 1999).

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

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

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

32. 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.

33. 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).

34. Depreciation recognizes the cost of assets over the estimated period of time they are expected to be used in operations, rather than at the time of acquisition.

35. 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.

36. 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).

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

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

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

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

41. 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.

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

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

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

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

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

Chairman SHAYS. I am going to recognize Mr. Thornberry.

I am just going to read one quote from your boss, Comptroller General Walker, who said before the Budget Committee, no part of DOD is able to pass the test of an independent financial statement audit. Many have trouble putting together a financial statement, much less having an audited financial statement. Continuing financial management problems have real consequences for program management and resource allocation. For instance, DOD cannot properly account for billions of dollars of basic transactions, leaving the agency vulnerable to the misuse of appropriated funds.

Mr. Thornberry.

Mr. THORNBERRY [presiding]. Thank you, Mr. Chairman.

I appreciate the testimony from each of you.

It is hard to discuss this subject for regular folks and not come away feeling like we are talking about accounting moves and tend-

ing to make one's eyes glaze over, but it does catch your attention when you talk about trillions of dollars of accounting entries. And, Mr. Lieberman, in your testimony you talked about as—in fiscal year '99, DOD financial statements, as they try to go through, as I understand there were \$2.3 trillion worth of accounting entries that did not have adequate backup information, is that right?

Mr. LIEBERMAN. Yes, sir.

Mr. THORNBERRY. Now, that is hard to understand in a way, because we only spend about \$300 billion a year on defense. But, as I understand it, it gets back to something Mr. Steinhoff was talking about; and that is we don't enter this information right the first time. We reenter it and reenter it and reenter it, and you are talking about trillions of dollars by the time you add it all up. Is that how we get to such huge numbers?

Mr. LIEBERMAN. Yes, that is a gross number. That portrays how many adjustments are made to the automated record.

Mr. THORNBERRY. And I assume at each step of the way there is room for error or mistakes—or at least confusion—if you have to reenter each of these entries so many times to end up to \$7.6 trillion total in errors.

Mr. LIEBERMAN. Sure. What we need is a seamless system where the information moves from its source right into the financial statements without having to be moved between incompatible systems with some sort of jerry-rigged crosswalk process.

Mr. THORNBERRY. Because I understand now one of the problems now is DOD's books do not reconcile. They don't add up with Treasury's books. So the Department of Treasury and Department of Defense don't have the same numbers as far as how much money they have got or how much money they spend, is that right?

Mr. LIEBERMAN. Yes, it is a chronic problem that actually has major implications for the government-wide statement that GAO audits.

Mr. THORNBERRY. Mr. Steinhoff, I think everybody on the panel compares this situation with Y2K. And all of us were relieved at the way that Y2K worked out, and obviously it took an enormous effort. It took a fair amount of money by Congress. It took a lot of time and attention from the top folks at every Department. If you had to compare the magnitude of the challenge of Y2K for the Department of Defense and the problems we are talking about today for the Department of Defense, how do they compare?

Mr. STEINHOFF. I would say that this is a much greater challenge.

Mr. THORNBERRY. How much greater?

Mr. STEINHOFF. Severalfold. Y2K was really addressing a specific aspect of the systems for which there was a big unknown. People didn't quite know how a system would work in that environment, and they had to go through and find out how that system would work through analysis and end-to-end testing. And they had to work with business partners.

For DOD's current system challenge, you are really talking about revamping the entire management system. Mr. Lynn's plan is 900 pages long. We have had some issues with it. We have asked for more information. But he has a very comprehensive plan covering the accounting systems that he controls. In addition to that, you

have all of the other systems, such as the logistics systems, for which there are major initiatives ongoing that must be integrated. This is a huge, huge challenge.

Mr. THORNBERRY. Let me ask this—and I am just picking a number out of the air. If you assume that this challenge is three times bigger than the Y2K—and I am trying to be conservative—are we spending three times the effort and three times the money to solve the problem?

Mr. STEINHOFF. What will be important here is that the money be spent in a very wise manner. There have been literally billions of dollars spent on systems in DOD, and we have reported information systems development in DOD as a high-risk area. They had a major initiative back in the '80's, the corporate information management initiative where big dollars were spent without getting the expected result.

I think that these efforts can be funded. But, it has to be done following a disciplined process where DOD ends up with a result from the money spent, that they don't go to point C before they get to point B, and that it not be solely date driven where you have to have it on line by a certain date regardless of the risk. Of course, people have to be accountable for meeting milestone dates, but it should be done in a way where there is a disciplined process. And under Clinger-Cohen and under the various investment guides, there are, in essence, proven approaches to design and put in modern systems, which is what DOD needs.

Mr. THORNBERRY. Mr. Lynn, let me ask you, you heard the testimony that 80 percent of the problem of the information is outside of your direct control. It is in other systems throughout the Department that have to put the information in that feed in to the accounting systems. I would be interested, do you agree with that approximation? And, secondly, how are we going to solve the 80 percent of the problem that is outside your control and when are we going to solve it?

Mr. LYNN. I actually gave you the 80 percent number, Mr. Thornberry. That is an accurate representation. We had set up a Y2K process. We have signed the organizing memo this week. It is going to require a cross-departmental process. I am going to have to bring in the logistics, the acquisition, the medical personnel people to solve this problem.

More importantly than that, though, we are going to have to persuade them that solving the problem is going to help them do their job. To get them to do all this work and spend all of this money upgrading their systems, just to get a clean opinion in my world, is not going to be persuasive to a logistician. I have to persuade the logistician that the information that supports that clean opinion is going to help that logistician manage better. It is going to help him manage his inventory better. It is going to help him make better decisions. It is going to help him understand his costs. That is the crucial step.

Mr. THORNBERRY. You talk about persuading him. It will help him do his job better. Do you also need a stick to go with that carrot? And I don't know exactly what it will be, but you don't get more money unless you do it the right way or something.

Mr. LYNN. Being in charge of the Department's finances, I am not short of sticks, in fact. So we have ways. But I do believe this set of measures will help the logisticians, will help the acquisition managers of the Department. I think it is largely a matter of education and information. And indeed, not again to be disrespectful, but part of that has to come over to this side of the river in Congress.

We had an unfortunate problem with the defense bill this year. Our major accounting system that we proposed for the Army and for the Defense Agencies to try and help reform this system was zero. We got no money. That is going to, frankly, set back our reform efforts. It is great that this committee is having a hearing. We need for, frankly, the other committees to take ownership of this issue as well. It has gotten very little notice, and we need for it to get more.

Mr. THORNBERRY. Let me just say I agree. The difficulty you get is that either gets to be lack of confidence in the Department's plans to solve a problem and, with such tremendous other budget needs, then it becomes easier to take that money and apply it somewhere else, to health care or wherever it is. But this problem does have to be fixed, and we have to find some way to restore confidence that not just you but the whole Department from the very top all the way through is taking it seriously and will solve it.

Mr. LYNN. And, Mr. Thornberry, that is exactly what we are trying to do by working collaboratively with the outside independent bodies, the GAO and the Inspector General. I think they both testified that we are working together collaboratively and making progress, and I hope that they would share that information with these other committees because the key to the solution is the systems. If we do not get these new systems on line, there is no work around that will work in the long run.

Mr. THORNBERRY. I appreciate it.

Ms. Hooley, would you like to go ahead? We have a vote on. We may have to be coming and going some.

Ms. HOOLEY. I think a couple of people left to vote. I don't think I'll have time to finish my questioning, but let me at least start.

Let me ask you a question, Mr. Lynn. As I read the information for today and looked at some of the problems, the fact that one out of every three transactions needs an adjustment, those are sort of alarming things. I also was struck by the fact—and let me make sure that I am right on this—that you had no audits before 1990, is that correct?

Mr. LYNN. It is even later than that. This is a very new requirement.

Ms. HOOLEY. This is really the first time we have opened the books and sort of discovered some of the problems that are occurring.

Mr. LYNN. It is the first time we have looked at the books this way, I think is the right way to say it. The books have been treated for 200 years the way the Appropriations Committee look at them in terms of appropriations titles and, in term of obligations.

Ms. HOOLEY. Right, but if you look at sort of the whole management and financial management, we have really not had a system, is that right?

Mr. LYNN. The requirements for this kind of accounting are new in the last 5 to 10 years, that is right. Really, prior to this administration, very little had been done; and prior to this Congress in the early '90's very little had been done.

Ms. HOOLEY. Let me ask you a question. I think the appropriation was \$306 billion for defense. I mean, and you talk about trying to get that this year, Congress and the Defense Department had zero for financial management.

Mr. LYNN. No, no, that is not true.

Ms. HOOLEY. Well, what did they have for financial management?

Mr. LYNN. It is hard to break the budget down, but just, simply put, the Defense Finance and Accounting Service, which is the central agency for finance and accounting, had a budget of about \$1.7 billion.

Ms. HOOLEY. But for some of the improvements—

Mr. LYNN. That includes some of the improvements.

Ms. HOOLEY. OK. Is there a way from—I mean, can you—out of this large of a budget, is there some way to peel off some money from some other areas to help make some progress?

Mr. LYNN. That is exactly what we proposed. Unfortunately, the Congress didn't approve the major move, which was a new accounting system for the Army.

Ms. HOOLEY. OK.

Mr. LYNN. We proposed \$46 million. Congress provided zero.

Ms. HOOLEY. I am going to leave, so if I can come back with some questions. Thank you.

Chairman SHAYS [presiding]. This is our only panel, so we will have some time to cover it pretty well.

I would like to go back to that \$7.6 trillion; and I know, Mr. Lieberman, you attempted to make some explanation. I just want to make sure—we are basically looking—we are looking at a total Federal budget of \$1.7 trillion, a defense budget that is basically \$306 billion, and I want to know if this number just represents all the transactions that take place in a \$306 billion budget. In other words, is it buying fuel at wholesale, moving it to different areas, then accounting it, going into the planes, going into the trucks and so on? Is it just taking that 306 and just saying there's so many transactions along the way?

And what I would like, Mr. Lynn, for you to do is explain to me how you view those DOD bookkeeping adjustments. Are those mistakes, adjustments or just transactions, you know, 20 transactions times your budget? Mr. Lynn.

Mr. LYNN. Sure. Several—

Chairman SHAYS. First off, do you agree with this?

Mr. LYNN. I have no reason to question the audit.

The chart you have up there, of course, is apples and oranges. You have bookkeeping adjustments on one side and the budget on the other. What you would have to do if you wanted to do an apples-to-apples chart is try and find the total number of bookkeeping adjustments in the U.S. economy and put that number—and it would be, I think, outstandingly high or the total bookkeeping adjustments and the total Federal budget would be similarly high. But I don't really think that is a fair way to look at it.

Chairman SHAYS. Let us just look at it in terms of your budget, which is admittedly gigantic, but it seems like a tremendous amount of adjustments.

Mr. LYNN. It is a very large amount of adjustments. And I think you were going in the right direction with your earlier comments that it is the multiple stops that the money takes, each one being recorded, that is the cause for the multiplication for \$306 million up to \$7.6 trillion. In addition to that, the financial statement includes long-term liabilities. It includes a hundred years of medical liabilities, a hundred years of environmental liabilities. Those are in the hundreds of billions of dollars as well. So that is outside of our \$300 billion annual budget.

In a financial statement you try and look at your long-term liabilities and make an assessment of those. You also look at the value of your property, which is in the neighborhood of a trillion dollars. Those, too, are included. So there is some very large numbers on the DOD financial statement, and some of them are on several times, which is how you get to that.

I think the core of your question, though, goes to what is the meaning of the adjustments; and I think the meaning is the bottom line of all of our testimony. The fundamental cause of the adjustment is that we do not have a seamless system where the transaction gets entered at one end and goes through a series of automated steps to the financial statement. That is what you would like to have. That is what we aspire to have. It is the manual adjustments at each step that we have to now do as a substitute for that seamless system that is the cause for that adjustment. Achieving a seamless system is what we are about with this Y2K process.

Chairman SHAYS. I would like both GAO and IG to make any comment in regards to how I should interpret \$7.6 trillion in adjustments. I just want to know, is it mistakes or it is just transactions multiplied?

Mr. LIEBERMAN. Some of them are mistakes; some of them are corrections of mistakes. About \$602 billion worth of that \$7.6 trillion represent adjustments made by the accountants in the finance centers that are responsible for getting these feeder reports from the field and putting them into the financial statements. They recognize what they consider to be errors in the incoming information and change it to try to fix it.

Chairman SHAYS. Would it be like with my checkbook? At the end, I had my bank statement. I couldn't find the mistake. I just accept it and start from what the bank says and go from there.

Mr. LIEBERMAN. When we are talking about unsupported adjustments, yes, there are a lot of numbers plugged in to make things add up or force them to match other records; and there is no—

Chairman SHAYS. So we don't know why they don't add up.

Mr. LIEBERMAN. No, we don't.

Chairman SHAYS. We just know they don't add up. Doesn't that lend itself to tremendous potential for fraud?

Mr. LIEBERMAN. At the level we are talking about, these massive financial statements, I actually don't think that there is much fraud vulnerability involved. The fraud vulnerability is more worrisome in the inaccuracies and the records down at the local level, in the contracting offices, the payroll offices and, the personnel of-

fices. If we are making payments that we shouldn't be making or out of accounts that are overdrawn and what have you, that is where the rubber hits the road. What we are talking about here are compiling these end-of-year financial statements and their massive roll-ups of information.

I do think, though, that it is not fair to say we are talking about comparing those bookkeeping adjustments to any other bookkeeping adjustments by anybody in the United States. What we are talking about here is this population of between 17,000 and 20,000 changes which we believe were made to the end-year DOD financial statements. Now if you went to any of the large corporations in the United States and asked them how many adjustments they made on their end-year financial statements, the answer would be somewhere between zero and something that probably they could count on both hands.

Chairman SHAYS. Let me ask you, if they had to count them on both hands, they would be severely criticized, wouldn't they?

Mr. LIEBERMAN. This is something they do indeed try to avoid, and they would go back and question why their systems were incapable of getting it right in the first place.

Chairman SHAYS. Mr. Steinhoff.

Mr. STEINHOFF. I would agree with what has been said. A lot of the data comes from data calls where, because a system can't produce it, they call various activities and roll up the amounts. And you will have activities that will report a zero balance, and DOD will call to obtain the needed information. For example, you have adjustments that result from taking physical inventories and finding 35 percent more stock on hand.

There are many errors. I had mentioned in my summary statement that out of \$157 billion of payment transactions made in fiscal year '99 that \$51 billion of those represented an adjustment to a previous transaction. Now those are outside these adjustments, but that gives you some idea of the number of changes they have to make because a system is very complex and doesn't work well and the fact that they really don't have accurate data on an ongoing basis. It really defies logic to have \$7.6 trillion in adjustments, as you said, with a budget that is a small fraction of that.

Chairman SHAYS. But, Mr. Lynn, since we have two kind of critiquing here, I don't mind you coming back if you have any comment you want to make in regards to this.

Mr. LYNN. It is not really fair, two on one, is it?

I don't really disagree with the thrust of what they are saying. I think what they are saying is that a bookkeeping adjustment is not a measure of the budget. It is a measure of the need for automation in the systems. It is also, I think, a measure of just how new this requirement is.

I think the example I gave in my remarks was that when the logistics managers want to replace inventory, they want to know the latest acquisition cost. That is the number that is of the most relevance to them.

That is not the number the auditors want. The auditors want a historical cost so they can depreciate it. The logistic manager is less interested in that. So the systems that we have had to do inventory, in general, don't do that. They don't record the historical

costs. They can only keep one number. They keep the latest acquisition cost. It takes a manual adjustment, one of those adjustments, for a bookkeeper to look and try and estimate what the historical cost is for the financial statement.

Now what we need to do, and what we are doing, is to change the inventory system so it records both numbers. That takes time and money, and we are putting both against it.

Chairman SHAYS. Let me just say—Mr. Steinhoff, yes.

Mr. STEINHOFF. What also makes that more difficult is that, let us say the accounting wanted the latest acquisition, which is what they purport to have, oftentimes the items aren't on the system. So DOD has problems with recording all the assets it owns, and then it has problems with valuation, and those end up with a multiplicity of adjustments.

Chairman SHAYS. Let me just say, Mr. Lynn, in terms of fairness, I have been with Mr. Steinhoff and Mr. Lieberman where they have been far more harsh, so I think they are trying to be very fair here. Because there is a lot you could say about this. Let me just—

Mr. LYNN. Mr. Chairman, I am not suggesting they have been anything but fair.

Chairman SHAYS. I just have one—let me just put up the chart on Social Security.

A lot of people in the United States of America—and we do that with nine digits and, as near as you can—I can't count the bottoms of that. But it seems like there are 65 digits to an Army operation A&I maintenance code. I would love for you, Mr. Lynn, to explain to me why you think that is the case and what the logic is for doing it and what is going to happen to change it.

Mr. LYNN. The logic—those two are not really comparable. The nine-digit code there for the Social Security number is intended to record one thing, which is the name of the individual. That is what is recorded. The 65 digits have to record multiple and overlapping requirements. The office that is managing that particular account wants to have management information to know how much they are spending on paper clips and how much they are spending on rubber bands, and so on, so they have better understanding of their cost structure.

So some of the requirements come from the auditors. The auditors need to know certain things about the transactions, and those have to be recorded in those codes.

Some of the requirements come from the Congress. The Congress wants to know what year, and what appropriations title, and various other things about the money so that we can track it and report it in great detail back to the Appropriations and Armed Services Committees.

So each of those numbers has a purpose to report information to various entities who require it.

Now that said, would I like to reduce that? Yes, I would. If I can just finish, Mr. Chairman. I would like to be able to reduce that number, but to do that I have to convince some of the people who are now demanding information—the Congress, the program manager, the auditors, my office—to reduce their need for information.

I think the problem you are going for is when you have 65 numbers, and somebody transposes two of those numbers, we have an unmatched disbursement. It doesn't mean we have spent money we shouldn't have. It just means we can't quite match it because we can't find it because of those two numbers.

When you do that manually 5, 10, 15 times for an individual transaction, there is great opportunity for error. I would like to reduce the number, that number of digits, but, even more importantly, what I need is to automate the system so we only enter it once.

Chairman SHAYS. Only entering it once would make sense. But I am told—I don't know if it is permutations. I am told, if you get to 65 digits, the variations are so extensive that you could provide lots more information. And it seems to be an indication that we are still thinking in terms of separate units, and they add their requirements and we end up with this mess, and the sense is that somebody central isn't taking charge and saying this shouldn't happen.

Mr. LYNN. That is true. Because, as I say, I think we can reduce and try and eliminate overlapping. I am not really fighting you on that, but some of these I cannot reduce. I can try, but I won't succeed to reduce the requirements for providing Congress information.

Chairman SHAYS. Mr. Steinhoff and Mr. Lieberman.

Mr. STEINHOFF. I have got a couple of thoughts on this. It is my understanding DOD now has 46 data elements. The transaction on your poster board from the Army includes 13 different data elements. So they have 46 data elements, 271 characters in all, that might be used in some combination.

Also, if you had the same transaction in the Navy, you would have a different line there. In the Navy, you would have a total of 45 characters; and you would have 11 data elements covered.

In the Air Force, you would have 41 characters and 14 data elements; and they are not all in the same order as the other services.

So you have got each service, with a unique code, having a different number of digits and different number of data elements, all in a different order, in a stovepiped fashion, and then within a service you don't always have standard fiscal codes. So the Army itself might have different fiscal codes or different structures. So you have service unique transaction codes. You then have within service, nonstandard codes. It becomes extremely complex when you have all kind of data elements required by all types of parties.

It is my understanding that DOD's goal is to reduce it to five to seven data elements, to greatly reduce the number of data element; and, therefore, the transaction code would be reduced. And, therefore, to have a standard entry, whether it is O&M in the Army or O&M in the Air Force, it should be the same way.

Chairman SHAYS. I got you.

Mr. Lieberman.

Mr. LIEBERMAN. The probability of people making the right choices to get everything correct when they have so many choices in all of these fields is not all that great. I mean, I may be the only person in here who started life as a GS-9 budget analyst, but I used to be responsible for trying to make some choices on what

number to put in about three-fourths of the way through that type of string. And I will tell you, the people in the field don't understand what the difference is, don't understand what the criteria is, and they just plug stuff in.

So if we think that we are really shading things with this ultra degree of fidelity and getting back good information, I think we are, frankly, kidding ourselves.

This whole situation reminds me very much of where Federal Acquisition Regulations were, say in the mid-'90's. Every single part of the FAR had a good reason behind it and had been put in there for some specific reason that made a lot of sense to somebody, but over the years it just got bigger and bigger and bigger, and it reached the point where it could not be administered efficiently anymore. And I think that is what we are saying here. The Department really needs to do a zero-based review of what is possible, particularly in this era right now where we know our systems are not particularly capable.

Chairman SHAYS. I am struck by the fact that, with all the different things that need to happen, they don't have to wait. These changes can happen simultaneously, and I hope they do.

Let me just say, Mr. Lieberman, you said you were a budget analyst number 9, but I was noticing from your bio that you also have a Bronze Star and have gotten other military awards, so your affection for the military goes before you got your budget analyst requirements.

Mr. Spratt, I don't know whether to go back to Ms. Hooley—would you like—OK. Ms. Hooley.

Ms. HOOLEY. Thank you. Sorry I had to leave to go vote.

Mr. Lynn, I just want to continue sort of with the questioning where we left off about when you look at your budget and look at your needs for financial management—I mean—and at least what I read, that we have a hard time keeping track of our inventory and so forth, is that right?

Mr. LYNN. There are certainly issues with our inventory.

Ms. HOOLEY. I mean, is it possible to not—to build one less tank or do something that would give you some money to put into your financial management?

Mr. LYNN. We have done that. Inventory really is only a corollary to financial management. We need—within the inventory system—a module that would report the financial information to the finance and accounting systems, but what we need to do is do that as part of an overall upgrade to the inventory systems. We are doing that.

We have an initiative. The phrase used in the logistics world is total asset visibility. What they are looking for is what most commercial operations had moved to and what we had partly moved to, is where you know where every piece of equipment is at every time, with barricades on the rest. That is the step we are trying to take in the inventory word.

I am only tangentially related to that. I am basically trying to piggyback onto that by making sure we have the right financial module so I can report the financial information both accurately to the managers and in a way that is auditable for the financial statement.

Ms. HOOLEY. But doesn't that all work together?

Mr. LYNN. Absolutely.

Ms. HOOLEY. I mean, when you have acquisition, it automatically goes into inventory and where it is so that you have some accounting?

Mr. LYNN. Yes.

Ms. HOOLEY. Part of that process—I mean, obviously, doing what you are trying to do isn't cheap. What do you need and what kind of goals do you have for next year, for 5 years from now that will get you to where, again, you have a system? And I am—I mean, I understand what audits do. They certainly point out some problems, but they don't solve all your problems. So that we at least get to the point that we know what we are doing and you don't have to reenter things three times and you don't have accounting for huge amounts of money that you know what you have in your inventory, when do we get there, how do we get there and what is it going to take?

Mr. LYNN. Let me break that down a bit.

In the finance and accounting world, which is one I am most directly responsible for, we are two-thirds of the way home. We have started, when we came into office, to try and reduce those 330 systems that were all noncompliant, none of them met accounting standards. We are down below a hundred now. By 2003, we are on track to get it down to about 30.

Just to give you a benchmark, at 300 we were way, way behind any kind of commercial operation. At 90 to a hundred, we are kind of in the middle of the pack of a major Fortune 500 or the top end of the Fortune 500 companies. That is about the number of finance and accounting systems they would have. When we get down to 30 and below, we will be in a world-class position. That will be in terms of the standards, and that is what we seek to achieve.

As we have all testified, that is actually only 20 percent of the financial data. The other 80 percent is harder because it is in the other systems. We have set up a Y2K process to try and upgrade the financial modules. The first thing you do in Y2K is awareness and identification, try and understand what your systems are and where they stand. That is the process we are in now.

We think there is about 70 systems right now, but we are refining that, that are critical. We will target those systems and try and upgrade those. And my personal target—this is more personal to me—is what I would like to do is, before I leave in this administration, is set up a system so that the next administration coming in will not push this problem aside, which will, frankly, be their temptation. If it looks too daunting and too expensive, they will push it aside because they are going to have to deal with strategy and weapons decisions and a whole series of other things. What I would like is, within the term of the next administration, that they could achieve a clean opinion.

Ms. HOOLEY. So you are looking at the next four and a half years.

Mr. LYNN. In the next four and a half years, if they could look at reasonably what has to be done and they could think that they may be able to get a clean opinion. Now to do that they are going to have make substantial progress on those feeder systems. That is the target I would lay out for you.

Ms. HOOLEY. That is for the 20 percent of the systems.

Mr. LYNN. The 20 percent we are on track.

Ms. HOOLEY. It is bringing the other 80 percent—

Mr. LYNN. It is bringing that other 80 percent in that is the key. I don't have fear as an administration change for the 20 percent. They will continue along the lines we have. It is very well laid out, and everything is pretty well set. I want them to be in a similar position for the 80 percent so that they will see a process, they will see a plan, and they will understand the budget implications and, most importantly, they will think it is achievable. Nobody up until this point has thought that it was even within the realm of possibility DOD could achieve a clean opinion. I think we are now getting to—we are not there, but I want to put it within reach of the next administration.

Ms. HOOLEY. Well, I, frankly, think we have to make that happen.

Mr. LYNN. I couldn't agree with you more.

Ms. HOOLEY. It is not an option not to have that happen, at least having read the background information.

I am going to change line of questioning for just a little bit and talk to Mr. Lieberman for a second, ask him some questions. There are a lot of expenditures for contractor services out there, and they certainly comprise a huge acquisition program in their own right. And, in fact, the largest subcategory of contracts for services was for professional, administrative and management support services. In fact, spending grew by 54 percent during these last fiscal years. And according to your testimony last March 16th before the House Subcommittee on Government Management, Information and Technology, spending on outsourcing will continue to grow as outsourcing initiatives expand. And I understand that last year you undertook a comprehensive audit to look at service contracts reviewing 105 Army, Navy and Air Force actions valued at \$6.7 billion for a wide range of professional, administrative, and management support services amounting to about 104 million labor hours, about 50,000 staff years. Would you like to comment on the results of that audit?

Mr. LIEBERMAN. Yes. The results were dismaying. Every single one of the contract actions that we reviewed had major flaws in it—poor cost estimating, ignoring the rules for competition and a sundry other things. The Department has responded very positively to that audit. There has been no quibbling about whether there is a problem or not. Everyone recognizes that there has been a lot of acquisition reform emphasis on buying hardware, but next to none on buying services.

You are right. We are now spending over \$50 billion a year on services, so this is a gigantic acquisition program in its own right. The problem basically is contracting officers are not taught how to buy services. The contracting officers tend to gravitate toward buying hardware, that is where the career enhancement lies, not buying mundane things like computer maintenance or something like that. So we have had very poor training for them. We also need to look at improving policies and sharing more information.

Corporations solve this by establishing centers of excellence in their contracting offices and having certain contracting people do

just services contracts. So the Department has agreed with our recommendation that they ought to look at that concept.

Ms. HOOLEY. Do you have—have they talked about when they think they can get this done?

Mr. LIEBERMAN. Well, they are working on enhanced training right now. I don't really have a sense for how long it will take to turn this around. We are talking about having to retrain thousands of people here, so it is going to take a while. And I really welcome your questions because I think this is an area that is terribly important and has been overlooked, in all the acquisition reform dialogue for the last several years.

Ms. HOOLEY. And I think the monetary impact for these deficiencies have to be just enormous.

Mr. LIEBERMAN. Yes. There is no doubt we are making bad procurement decisions, paying too much for certain services or not getting what we are paying for in a lot of cases.

Ms. HOOLEY. A lot of times—at least this is what I read or heard—that a lot of times as we contract out we also shortchange workers on their pay or benefits. When you talk about people that—I mean, our—first, there are problems with contracting out. Are we saving any money contracting out?

Mr. LIEBERMAN. Well, when we make a decision to contract out, there is a very rigorous process enshrined in Office of Management and Budget Circular A-76 that requires cost comparisons between the public and private sectors; and DOD policy is only to contract out when it is going to be cost effective to do that. The problem is, frankly, that with this being done on a mass scale and with cost data being rather unreliable, there really is completely inadequate follow-up, in my opinion, to see what the results of outsourcing have been. We have many things that look good on the front end, but down the road the cost picture could very well change, and we don't have a very good handle on whether the savings actually come to pass and are sustained or not.

Ms. HOOLEY. Well, and my question is, also, do sometimes we save money because when we contract out they get less benefits or lower wages? And at a time of really high—I mean, we have—employment is up, but we have very low unemployment. I mean, sort of the quality of people you get, too, if we are actually paying them less on contracted-out services.

Mr. LYNN. If I might add, we have done some studies; and what we found is that we save when we do an A-76 competition. We save money regardless of how it comes out. We save 20 to 30 percent regardless of whether the government wins the competition or the private sector wins the competition.

On the government side, just the process of going through the most efficient organization and developing a more cost-effective approach has been very effective; and we found that on about half the occasions the government does win the contract.

Mr. LIEBERMAN. But I agree the quality question is very, very hard to measure. Whether we are really getting sufficient quality when we contract out for services largely depends on how smart we are about writing the statement of work and then enforcing the contractual terms. With the downsizing of the acquisition workforce there is a whole lot less oversight on contracts, particularly on

service contracts. So there is a very valid question about whether we are getting the same quality service as we had before.

Ms. HOOLEY. Well, and I am looking for efficiency, saving money, but I also look for quality. And especially—I mean, if we want the strongest Defense Department, I want some quality there as well.

Mr. STEINHOFF. One of the issues, if I might add, and this was reported by GAO last July, is, going into many of these outsourcing studies, the baseline costs are estimated or anecdotal. They are not always fully fleshed out, and there is a difficulty then in really tracking the impact of changes. So the ability to have better metrics and to be able to really tell the result both financially and qualitatively is very important. That would get to your issue and get to really the bottom line: Is it qualitatively as good and is it costing less?

Our work has shown that when DOD outsources it competes the government. It does reduce the cost, as Mr. Lynn said. The type of question you ask is a very good question. It gets right to the heart of the issue, and it gets to the heart of what a good financial management system would produce—not a financial accounting system, not a financial statement, but that end game I talked about. It would help you develop metrics and would tell your performance in a variety of ways.

Ms. HOOLEY. I just want to finish up with Mr. Lynn this line of questioning. Do we collect any information when we contract out about what kind of pay or retirement benefits that the contracting out people have?

Mr. LYNN. There are—I am going to be little bit out of my line on this. There are certain standards they have to meet, Davis-Bacon and others, that are legislative. And I would have to get back to you for the record whether we have—what processes we have beyond that.

Ms. HOOLEY. OK. I am really interested in knowing; and, if you don't know now, if you could get back to me.

Mr. LYNN. I understand the question. I just don't have it in my head.

Ms. HOOLEY. OK. Thank you thank you very much.
[The information referred to follows:]

MR. LYNN'S RESPONSE TO MS. HOOLEY'S QUESTION ABOUT THE PAY OR RETIREMENT BENEFITS OF THE CONTRACTING-OUT PEOPLE

A key part of an A-76 competition is the requirement that each offeror submit a detailed cost proposal that identifies the proposed labor hours, by labor category, of the people who will perform the work under the contract. This includes the contractor's proposed compensation of those people, including their pay and retirement benefits. This is a necessary part of the overall cost comparison that leads to the decision regarding whether or not to contract out the requirement.

Mr. THORNBERRY [presiding]. Mr. Spratt.

Mr. SPRATT. Thank you very much.

Mr. Lieberman, you said you might be the only one here who started your career as a GS-9 budget analyst. I would like to introduce you to Hugh Brady, who started the same way, working for Mr. Nemfakos and—many years ago, so we should let him sit up and ask a few questions.

Mr. LIEBERMAN. I don't want to have to make any more confessions.

Mr. SPRATT. I went to work as a first lieutenant in the Army for Bill Lynn's predecessor, Bob Moot, who was the Assistant Secretary of Defense and Comptroller. Interesting case. Mr. Moot had grown up in the military system. He had been a warrant officer in the Second World War. His predecessor, who had polar, opposite training, was Robert Anthony. McNamara brought him down from Harvard Business School, and Anthony set up, to his credit, many of the things that we still live with today. To the extent we have program budgeting, that was his creation; and to the extent we have POMs and things like that, most of those were created in that period of time.

One of the products of the little group that Anthony created was the SAR, Selected Acquisition Report. This was an effort at doing a variance report when we had none.

I guess I state my thesis first. The problems we are talking about today have been with us for a long, long time; and while the progress you have made I think is commendable, some progress is being made, we have still a long way to go; and we shouldn't fool ourselves about that.

The SAR is a good example. Mel Laird came up here to testify. This was in the peak of the Vietnam years, and there was a lot of procurement activity going on. Costs were going up, inflation was overtaking contracts, and there was no baseline. There was no good way to measure actual cost against promised costs, actual schedule against promised schedule, actual performance against the supposed performance when the system was originally authorized.

And Mr. Laird told the Senate Armed Services Committee—Mr. Schweiker, I think, was then on the committee—don't worry about that. We have just had Booz-Allen-Hamilton come in, and we are setting up a variance reporting system—which, as it turned out, wasn't true. Not that he was misrepresenting it to the committee. He really didn't know that Booz-Allen had just come in and taken one or two or three systems that GAO was working on out of about 50 systems. But having said it the Department was bound to go ahead and create the selected acquisition report. That is how that was extracted from the Department of Defense almost inadvertently.

When I came here in 1983, since this particular report had been kind of spearheaded and shepherded through the group that I worked in, the operations and analysis group, I went down to the committee where I had a seat. I was on the Armed Services Committee, still am, and I asked to see the selected acquisition reports. I wanted to see how much they had evolved between 1970 and 1983.

I found, to my dismay, they hadn't evolved at all. They were still pretty static, and they weren't used—and that was the key to it. They weren't useful to the users and, therefore, there weren't these evolutionary improvements you would expect in a document that was used continually. And the users would say, gosh, it would be good to have this, and we don't need that, and gradually the system improves over time if it is an actively used accounting document for the purposes that it was intended, namely, a variance report.

And I have to ask myself about a lot of this data that you are generating. Do you think within this complex realm of all these statements, all these source documents and entries, that you are really doing a lot of stuff that is not useful to anybody and that is part of the problem, that this is overcomplex and it could be streamlined, you could strip out some of this stuff and the users would never miss it?

I put that question to all three of you.

Mr. LYNN. It is a hard question. I think it is going to depend on where you sit. I think that you will never persuade the Deputy Assistant Under Secretary for Logistics that he does not need that data, and he will always insist that he needs that data to review the budgets to be able to understand what is going on in his area.

And I think you might find a few things where people just aren't using the data any longer, no longer want it. I think, though, if you wanted to go the direction of true streamlining you would have to centralize the consideration and make a corporate judgment as to whether the value of the data would be something that is worth the cost of collecting it, and make that judgment. Right now, those two are divorced. The logistics guy does not pay, in general, to get that data.

Mr. SPRATT. Are the users really using these documents? Are the auditors simply using them to satisfy themselves with respect to issuing an opinion? Are these really management documents that users are resorting to to make sound management decisions?

Mr. STEINHOFF. Mr. Spratt, the audited financial statement is not the end game. It is one marker. It is one way to measure how a stewardship responsibility has been carried out. It is a way to pinpoint issues.

One of the things that this process has done in DOD is to put some light on some of the major issues that have been there since your time at DOD and before, shone some more light on those problems.

Financial reporting can be of use in a variety of ways. One, you want to know what are the cost of operations. Right now, DOD doesn't really know the cost of operations. You know how many obligations were incurred against the budget, but what was the cost of carrying out an operation? You want to know what are the some of the unfunded liabilities. Right now, the budget scenario is pretty good. We are running a surplus. Down the road, as the Comptroller General has testified, we face some very difficult challenges.

You want to know what are the present and future liabilities, whether it be retiree costs or environmental disposal or medical costs going forward; and a financial statement can provide that to you. You want some assurance that they can reconcile their cash account. You want to know what is owed to them. You want to know what they own and the condition of their property.

The financial report itself is not at all the panacea to DOD's management challenges. It is one mechanism. It is one measure. At a minimum, this is something that any organization should be expected to produce. And in the private sector they expect those reports to be out 4 to 10 days after the close of the year, close of the month. They expect them to be correct. They don't want to spend

a lot of time on them, and the information flows immediately from the system.

In the long term, what is important is that this Department, as well as others, have a financial management system in place that is far broader than a financial accounting system; a financial management system that provides to you rich, useful, relevant data. The key to the CFO Act is useful data that is relevant, timely, and reliable for the kind of decision you are making.

Right now, the Department, as you are aware, is ordering inventory it doesn't need. At the same time, it is suffering from not having parts it needs.

Mr. SPRATT. Let me give you just an example from raw data, that gives rise to my question.

Somebody in his testimony said that there was \$7.6 trillion worth of entries in 1999. The defense budget in accrual terms that year—this is problematic because we don't think in those terms—was \$378 billion. I think in cash terms it was probably 300-, \$270 billion. So right there you have got a complexity. You have got to have a cash set of books and an accrual set of books, if you want to do what you were talking about and keep tab of future liabilities you are incurring from present operations. But, in any event, \$7.6 trillion of entries in a \$378 billion budget. That means you are turning over that \$378 billion about 15 times, maybe 20 times—20 times.

Mr. STEINHOFF. I will defer to my colleague here. Those were actually the entries that were made to prepare the financial reports. There were more entries than that.

Mr. SPRATT. On a \$378 billion budget you have got 20 entries for every dollar.

Mr. LIEBERMAN. Well, that is the way the math works out. We still are comparing apples and oranges here, but fundamentally you are right. This is a massive administrative effort. Matter of fact, it is a heroic effort to try to satisfy these requirements. Obviously, it is costly. I don't know how much it costs to do it, but it soaks up lots of man hours and unfortunately right now is ultimately futile, because the end result still is not acceptable.

Mr. LYNN. Mr. Spratt, if I could just add one thing. When I came into this position I was actually very skeptical of the need for a financial statement for the Department. No one reads it. It is not used. I mean I would guess no one in our authorizing appropriating committees has ever laid eyes on it. It is not a usable document for those purposes. Nor would you expect it to be. We are not a private corporation. We are not going to sell the place. We are not going to seek bonds. We are not looking for loans. So in the usual commercial reporting a financial statement is a very, very limited utility for the Department of Defense.

What has persuaded me to pursue this is that I think—and particularly it is the collaboration with the IG and GAO is critical. Getting a clean opinion can, as Mr. Steinhoff indicated, be the report card that the management systems you have are providing the information to the managers that need to make decisions, that you understand your cost. And what we are trying to do is make sure that we modify the requirements so that—I think along the lines you are saying—they are producing appropriate data.

For example, we don't need to depreciate M-1 tanks. That is not how we decide to make decisions. We use the threat and technology and a whole series of other things, not the depreciation value of the tanks. So that is not a useful set of information. It might be on a commercial set of books, but not for us.

On the other hand, commercial depreciation of real property is of real value. Knowing how much we pay for property, as you have done in your earlier life, that is a critical component to figure out how much maintenance you ought to be doing on that property. That is useful data. What we are trying to do is work with the audit community to try and narrow down and get an achievable set of objectives that will allow us to get a clean opinion but, more importantly, produce the management information that our senior leadership needs.

Mr. SPRATT. In that regard, clearly you have got lots of formidable problems. I think you have made progress, but you have got lots of hurdles ahead of you.

How much of your problems are tangible? By that I mean, due to outdated procedures and systems, both software and hardware? And how much of your problem is attributable to intangible causes such as the lack of really sharp and capable people to get the job done, particularly at the accounting helm?

Mr. LYNN. We have made a transition at the start of the decade where we pulled all the finance and accounting organizations out of the individual military departments and set up the Defense Finance and Accounting Service. I think that, right now, that is an extremely strong organization; and I would hope in the next decade it will become a world-class finance and accounting center.

We have just set up a new set of personnel standards, a certification process with the testing process so you can become a Certified Defense Financial Manager. This involves a whole series of courses prior to getting the certification, then continuing professional education afterwards. I think with that kind of initiative we have the talent that it takes. I think the critical and the overwhelming problem is upgrading the systems. The problem is with the systems at this point, not with the people.

Mr. SPRATT. Would the General Accounting Office care to comment on that?

Mr. STEINHOFF. I agree that they face a monumental—what I call world-class systems challenge—to address problems in all their business systems, with financial systems being an integral part of their general business systems. Also, human capital is going to be a very more important area.

The Comptroller General has spoken about the crisis in government, the fact that government has to deal with human capital and look ahead. A large number of employees can retire soon. There are certainly other opportunities for them in this economy. The work that DOD is now doing to rebuild its staff and to provide training is important. The study we did a few years ago found that very few of the folks were being trained then. Now they have got a training program that is under way to better professionalize their staff.

Mr. SPRATT. Go ahead.

Mr. STEINHOFF. All agencies are going to have to prepare themselves for the technology age and the changes that will come as we

actually get systems in place. So Defense is going to have to start planning for that era where they are not going to need as many accounting technicians, or people that enter the number of massive transactions. To the extent you can get away from transaction processing you are going to need a different type of person, a person with an analytical background, financial analyst, financial systems people; and you have to begin planning for that transition as you move into the technology age.

Mr. SPRATT. To give you an example, some years ago, when I was interested in doing some work with the Selected Acquisition Report and improving it, I was hiring a staffer to work for me in the defense area on the Armed Services Committee who had some background in this. I put that out in the RFP for possible employees and had a couple of applicants come to me and say, well, I have been working on such and such a SAR. And I said, how is that? Well, they worked for local consulting firms; and those firms were contracting agencies for doing this Selected Acquisition Report.

It struck me that every program management office ought to be made to do the Selected Acquisition Report for two reasons: If they don't know how to fill out a Selected Acquisition Report, they aren't competent to manage the program; and, secondly, if they do it themselves, then they are going to have to dig into the data and understand it and be responsible for defending it if and when it goes wrong.

Are we undercutting our own accounting efforts by outsourcing too much?

Mr. LYNN. I don't think so. I actually would, in the area of audited financial statements, which is quite different than the SARs you are talking about, with the program offices I am actually looking to outsource more. We need more professional accounting help in terms of the remedial steps that are required to get a clean opinion than we have in-house. I think we only need it for a relatively short period of years. I wouldn't want to bring people on full time, but I think we are interested in, frankly, hiring Big Six accounting firms to go through with us what it is we need to change in terms of the system and set up a plan so we can get a clean opinion. So I think we are interested in using outsourcing in that sense.

Mr. SPRATT. What are the real—what are the worst—most intractable and difficult problems? For example, let me ask this. The number that you have got there for a Navy source reporting, that lengthy number in one of your testimonies, I am not sure, covers the whole width of the page. I have an old friend who was a captain who was in charge of trying to get the Navy's inventory control system and CINCPAC in working order; and his perennial and continual and final complaint was that the users riddled it by requiring that it be adapted to their own particular, peculiar and idiosyncratic needs and that there wasn't a czar sitting on top of the system saying, no, we are going to keep this thing streamlined.

Has that been a problem? Are we suffering the consequences of that now, where we try to please the users too much and they proliferated some of our management systems to the point they are too complex?

Mr. LIEBERMAN. Yes. I think the capability of the technology that we have nowadays seduces people into thinking they can collect in-

finite amounts of information accurately. So managers don't really do very good planning, I think, in terms of figuring out the cost effectiveness of requiring this extra data, how much time is going to be involved in somebody plugging these numbers in and how much effort is involved in analyzing what the right number ought to be.

Ultimately, we don't have any such thing as a sunset provision on these requirements; and so, over time, what is necessary to collect today may not be used any more. You mentioned the SARs, and you are right. There is very little feedback that I am aware of from the Congress nowadays. They get the SARs, and nobody knows whether they are being read or not. Many of our requirements in all of our databases were generated years ago by somebody who had some legitimate need at the time, I am sure, but we would be worlds better off if we were more efficient about regularly revisiting these things and making everybody rejustify the need for collecting the data.

Mr. STEINHOFF. As you are aware from your past experience, there is service-unique transaction coding and processing. Many things are nonstandard. Standardization is really a major issue. In order to achieve standardization, you really have to break down those stovepipes of each service doing its own things. People have to come together and agree to a standard approach, a standard system, a reengineered process that is much simpler, much more straightforward, and provides the basic data needed to provide fundamental accountability.

There was a study done recently for the Air Force where the consultant found in one area that the service could reduce by 78 percent the number of transactions it processes, a reduction of 155 million transactions, by changing its processes.

A lot of economies are possible through standardization and simplification, which is a goal of DOD. A real challenge is to get past the culture that you saw with each service having its own unique approaches and each manager thinking they knew better how to do something; and that cultural challenge is hard to overcome.

Mr. THORNBERRY. Mr. Spratt, if I could turn to Mr. Bass. It has been about 20 minutes or—

Mr. SPRATT. One final comment, if I could.

Mr. THORNBERRY. Sure.

Mr. SPRATT. That is, you notice the Y2K effort had worked, and one of the reasons it worked is that senior management took it seriously. This was clearly an imperative. And I think we probably have to same kind of imperative attention to this, and that includes the Congress of the United States.

I have been on the Armed Services Committee for 18 years. I have been on the Government Operations Committee. And we do far too little oversight into this very mundane but extremely important area. And I think if we gearing to expect success we have to have more hearings like this and we have to have sort of a common purpose between us where we all work and agree that this is a principal focus of our efforts.

Thank you for coming and testifying. I think it has been a worthwhile hearing.

Mr. THORNBERRY. I agree.

Mr. Bass.

Mr. BASS. Thank you, Mr. Chairman. I appreciate this hearing, and I agree with Mr. Spratt that it is important. We don't spend enough time on it.

This hearing is entitled, Pentagon Financial Management, What's Broken and How to Fix It. You probably can't answer this question: Are you the three best possible people we could have up here—one from GAO, the two people in the Defense Department—that understand the most what is broken and how to fix it? Have we got the right guys here?

Mr. STEINHOFF. I hope so.

Mr. BASS. OK. Two of the three of you aren't CPAs. Is that problematic or not? Does it matter? Let me qualify that for a second.

Mr. Lynn, you are a graduate of Dartmouth, class of '76. I am Dartmouth class of '74. So you don't have a problem. You are well qualified.

But, in all seriousness, I know that financial problems assailing the Department of Defense are far more than that which an accountant can address. And I am not an accountant, but I run a small business, but I don't handle the financial statements and the details of my business. I hire an accountant to do it. Maybe that is what you are doing yourself.

And I don't want you to say that you still need to be accountants in order to handle the problems of the Defense Department, but we have had—I have been in a number of these hearings, and we get spiderwebs like that one over there. We don't seem to be making an awful lot of progress overall.

I would suggest that maybe this has been tried 50 times already, that the DOD establish some sort of a Task Force of two or three of the best accountants in the country, perhaps two or three or one or two of the best management consultants, private management consultants, people that consult for governments, people that may consult for very large corporations, to try to pull their management and financial structures together and start by making them understandable.

I am on the Intelligence Committee. I get acronyms constantly. Even Mr. Spratt had a few acronyms I had never heard of. And really try to get your arms around the bigger issues here. I don't understand most of the material that has been brought forth in this hearing, but I do know that we have severe systemic problems in the Department of Defense. We always have. And they don't seem to be getting an awful lot better.

You guys have—any of you three have any observations about this? Mr. Lynn, just remember, you are all right. Dartmouth is OK. You are off the hook.

Mr. LYNN. I have a couple of comments, if I could.

You are absolutely right. We need accounting expertise. And in response to your question, you have the best people—actually, the best person, from the Department's perspective, is sitting directly behind me, is Nelson Tovey, who is the Deputy Chief Financial Officer. He is the one that honchos issues for the Department.

We have the requisite expertise. What I would suggest is the problem in prior years has been that only the accountants understood the problems, and these are problems that affect management at the highest levels. This is information that needs to come

to management, and if it stays below that we are not going to be able to solve the problems. So we need to pull nonaccountants, frankly, and it is not just myself but it is my colleagues in the logistics world, and the acquisition world, and the medical world. If we cannot pull them in and persuade them that they are going to have to make these upgrades, we are not going to succeed.

Your suggestion of an outside panel I think is a good one, but I am pursuing it in a different way. I found, in general, that outside panels of observers are helpful in perhaps identifying a problem. They are almost never equipped to get seriously into the nitty-gritty of solving it. To do that, you have to pay people.

Mr. BASS. I am not suggesting they be free. For the amount of money you are losing and so forth, this would be a drop in the bucket. You pay these guys lifetime salary.

Mr. LYNN. And that is the direction where we are headed—I can't remember if you were in the room when I was discussing this with Mr. Spratt—is to hire Big Six accounting expertise to go through the specifics of what we need to do to upgrade our systems. We are in the process. The Defense Finance and Accounting Service and the Defense Logistics Agency have embarked on this. The other agencies in the Air Force—I am working on the Army and the Navy now—are working similarly.

I do not think we have—and that is where I agree with you—I do not think we have enough in-house expertise to solve this problem, and we do need to go outside to do it. I do think it needs to go above the accounting expertise in the Department.

Mr. BASS. Being an Under Secretary you are also a political appointee, right?

Mr. LYNN. Completely.

Mr. BASS. So another problem we have here is you are the top guy. There may be somebody else in your position next year at this time. Do you have a fixed term?

Mr. LYNN. No, no. I serve at the pleasure of the President; and the President, obviously, will change on January 20th.

Mr. BASS. Every 8 years or 4 years, you have a completely different person involved in the overall financial management of the Department of Defense.

Mr. LYNN. That is absolutely right.

In answer to Ms. Hooley's question, I indicated that one of the goals that I have, as the Department's Chief Financial Officer, is to leave in place a foundation that the next administration will want to pursue these initiatives because they are achievable within that time.

Mr. BASS. Has your job been frustrating?

Mr. LYNN. No, I actually enjoy my job quite a lot.

Mr. BASS. How long have you been on the job?

Mr. LYNN. In this particular job, since '97; and I was in the Pentagon prior to that for the first time in long-term planning.

Mr. BASS. That is all the questions I have, Mr. Chairman.

Mr. THORNBERRY. Thank you.

Let me just have one final question for each of you.

Part of the problem is—I think everybody has alluded to—is you get down into the weeds of this thing and you are into territory that is kind of hard to pull together and make some sense in a

larger sense. But, in essence, I think everybody agrees we can't really keep track of where all the money goes in the Department. We don't know everything we own. We have liabilities that it is hard to get a handle on. And it is because, in part, we have systems that started a long time ago, for a variety of reasons; and it is very hard to make change; and, at best, we are on track to fix 20 percent of the problem.

What I want to get back to, I guess starting with you, Mr. Lynn, is, OK, you want to get in, to try to get—keep your 20 percent going but also set things up for the rest of the 80 percent to be solved, regardless of who wins the election. And the new administration is going to have to review strategy, they have got to figure out what fighter aircraft they are going to buy and what they are going to do with aircraft carriers, all these problems. In short, simple language, can you explain to me why the new administration ought to care about this other 80 percent and making sure we get it fixed? Why it is important that they focus on this issue?

Mr. LYNN. In a single sentence, because the Department—

Mr. THORNBERRY. It does haven't to be one sentence. It has to be short and simple so I can understand it.

Mr. LYNN. The Department needs accurate, timely and reliable financial data. The key to that is—we have done two of the three steps that we need to produce that. First, we have consolidated all the finance and accounting operations. We have done it 2 years early. We have brought it down from hundreds of systems, from hundreds of sites, down to a couple—to two to three dozen. That is a major accomplishment, and that is the foundation on which any other reforms are going to proceed.

The next step, as you indicate, and it is the hardest step, is to get the financial information that is produced outside the finance and accounting system into that finance and accounting system in a reliable way. This means a seamless automation from the logistics area to the finance area, from the acquisition area to finance area. That is the key. We have set up a process to do that. I think that that process will show that it can be successful within the next term; and I think, frankly, that is the biggest incentive. I think a new President and a new Secretary of Defense might well be the owners of a clean financial opinion before they leave office. That is the biggest incentive I can give them to try and pursue this.

Mr. THORNBERRY. Mr. Steinhoff, if I am worried about what I am going to do with China and proliferation of missiles and terrorists and Middle East and drug trafficking, why should I care about this?

Mr. STEINHOFF. Defense is the largest, most complex entity, with worldwide reach; and as a steward or the head of that Department, I want to make sure I operate in an effective, efficient manner. I want to assure that I am fully accountable to the taxpayer for the money I have been given to carry out that mission. I want to make sure that the mission is carried out in the most effective way possible, that the troops have the items they need, that we do it at the least cost. And I want to have a high level of stewardship. I owe it to my Department. I owe it to the public.

There is another side to this, too. I would want to leave a legacy for the next person that came in, that they weren't burdened with having to worry about the back room, that the back room is taken care of; and they would be able to focus on business decisions, such as resource allocation and spending, which is why they really take the job.

When Mr. Lynn took this job, I don't think he took it to work in the back room, trying to reconcile these transactions. I think he took it trying to make decisions on the budget of DOD and the performance of DOD. So I would want to leave some kind of legacy that I, in fact, left a business process in place and the most complex operation, the most diverse, also had the finest financial operation.

Mr. THORNBERRY. Mr. Lieberman.

Mr. LIEBERMAN. I have to agree with what was just said, and I would like to add one point. I don't think this problem is insurmountable, and we shouldn't make more out of it than it is. The most important thing that needs to be done is to fix, Mr. Lynn says, 70 systems. I think it may be a few more than that. Well, DOD has between 5 and 7,000 mission-critical information systems; and most of those are being modified or updated at any given time. So this is a small population of the Department's systems; and with sustained top-management attention, I don't think there is any particular reason why all those systems can't be made CFO compliant within a few years.

Mr. THORNBERRY. Let me just suggest to you all that I think in some way this problem is like a virus on our defense efforts, because I think it weakens up—it weakens some of the support you get in Congress. You had some people voting against the defense appropriations bill yesterday because of the lack of confidence of how the money is being spent.

I think it weakens our effort to make good decisions as we try to sort out where we are going, the outsource, or put into health care and various sorts of things. If you don't have good data, it makes it very difficult. And it is the kind of systemic problem that is not glamorous but has huge consequences. And I would hope—

Mr. Lynn, there was a couple of questions related to zero-based review, whether it deals with this number or whether it deals with some of the things Mr. Spratt was talking about. I would like for you to think about, during your last 6 months or whatever, coming to us or to the Department with recommendations—don't worry about what the logistics people think they need. You come to look at maybe some recommendations on how we can improve this system and leave that perhaps as one of your recommendations to your successors. And we want to try to help and support that effort, because we do bear part of this burden as well. It is a big problem, and I think it is important.

I thank all our witnesses for being here; and, with that, the hearing is adjourned.

[Whereupon, at 12:05 p.m., the Task Force was adjourned.]