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OVERSIGHT OF THE FINANCIAL MANAGEMENT PRACTICES AT THE DEPARTMENT OF DEFENSE

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

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OVERSIGHT OF THE FINANCIAL MANAGEMENT PRACTICES AT THE DEPARTMENT OF DEFENSE

TUESDAY, MAY 4, 1999

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

The subcommittee met, pursuant to notice, at 10 a.m., in room 2247, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Biggert, Ose, and Turner.

Staff present: J. Russell George, staff director and chief counsel; Bonnie Heald, director of communications, professional staff member, Mason Alinger, clerk; Richard Lukas, intern; Faith Weiss, minority counsel; and Earley Green, minority staff assistant.

Mr. HORN. We're here today to discuss the status of the efforts at the Department of Defense to correct long-standing financial management problems. Again, in fiscal year 1998, auditors were unable to express an opinion on the financial statements of the Department of Defense or any of its services. Pervasive, crosscutting problems continue to plague the Department.

These weaknesses in financial management result in wasted resources and undermine the Department of Defense's ability to manage its annual budget, which exceeds $250 billion. In addition, these problems cause inefficiencies and ineffectiveness in the Department's management and oversight of approximately $1 trillion in assets, assets such as weapon systems, aircraft, vessels and related inventory and supplies.

In our March 31 hearing on the second annual governmentwide audit, the Comptroller General, when asked which Federal agency had the most significant financial management weaknesses, quickly responded "DOD, the Department of Defense."

This subcommittee has held numerous hearings exploring a wide array of issues facing the Department of Defense. We take seriously the need to resolve these financial management problems, as I'm sure the Department of Defense does.

We will explore these issues in greater detail today. We want to know what the Department of Defense is doing to resolve these deficiencies, both in the short term and in the long term. We need to be sure that we have a commitment of the top executives in the Department to resolve these issues.

These problems are severe. We cannot allow them to persist, and I'm looking forward to the testimony.

We have a very fine panel this morning. If we would have it on the front of my binder, it would help. We're going to have essentially one panel.

The opening witness will be the Acting Inspector General of Defense, who will be followed by the Assistant Comptroller General, the Under Secretary of Defense, and the Chief Financial Officer.

The routine in this subcommittee as part of the full committee is to swear in all witnesses. When we call on you, that statement is automatically put in the record in full. What I would like to do this morning is give you a great liberality to an oral statement; roughly 10 minutes for each principal witness; then, we would like to spend the rest of the time on dialog and questioning between both sides.

[The prepared statement of Hon. Stephen Horn follows:]

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"Department of Defense Financial Management: Serious Problems Persist"

May 4, 1999

OPENING STATEMENT
REPRESENTATIVE STEPHEN HORN (R-CA)

Chairman, Subcommittee on Government Management, Information, and Technology

We are here today to discuss the status of efforts at the Department of Defense to correct long-standing financial management problems. Again, in fiscal year 1998 auditors were unable to express an opinion on the financial statements of the Department of Defense, or any of its Services. Pervasive, crosscutting problems continue to plague the Department.

These weaknesses in financial management result in wasted resources and undermine the Department of Defense's ability to manage its annual budget, which exceeds $250 billion. In addition, these problems cause inefficiencies and ineffectiveness in the Department's management and oversight of approximately $1 trillion in assets – assets such as weapons systems, aircraft, vessels, and related inventory and supplies.

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This subcommittee has held numerous hearings exploring a wide array of issues facing the Department of Defense. We take seriously the need to resolve these financial management problems.

We will explore these issues in greater detail today. We want to know what the Department of Defense is doing to resolve these deficiencies, both in the short term and in the long term. We need to be sure that we have the commitment of the top executives in the Department to resolve these issues. These problems are severe, and we cannot allow them to persist.

We welcome our witnesses and look forward to their testimony.

Mr. HORN. Mr. Turner has joined us. And, Mr. Turner, you're free as ranking member to make an opening statement. You're just in time.

Mr. TURNER. Well, since I'm a little late, I will ask the Chair if I can file my opening statement for the record.

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

OPENING STATEMENT OF THE HONORABLE JIM TURNER
GMIT: OVERSIGHT OF DEPARTMENT OF DEFENSE'S FINANCIAL MANAGEMENT
MAY 4, 1999

I would like to thank the Chairman for holding this important hearing on financial management at the Department of Defense. The Department's operations are critical to our nation's security, and I think all will agree that it is crucial for the Department to manage its affairs in a way that adequately accounts for its funds as well as its assets and liabilities.

DOD receives more money in annual discretionary funds than any other federal agency—with a total budget for fiscal year 1999 of $262.6 billion. Yet, the Department's financial systems represent the single largest obstacle standing in the way of the federal government's efforts to obtain a clean opinion on its consolidated financial statement. It is disappointing that, except for the Military Retirement Trust Fund, every major audit of the Department and its services' accounts uncovered problems with the available financial information—problems of such significance that the audits could not be completed.

Recently, the Department has made some encouraging progress. It has submitted a biannual financial improvement plan to Congress and confronted some of its most serious financial problems with both long-range and short-term actions. Nonetheless, a great deal remains to be done, and it will most likely take years of sustained effort to address the most serious problems.

DFAS ~~still~~ has problems.

The Defense Finance and Accounting Service (DFAS) in Columbus, Ohio, made $746 million in improper payments to contractors in 1998, which means that defense contractors must return an average of **$2 million each day** to the federal government, because the Defense Department unwittingly overpaid them. This statistic is unacceptable.

The magnitude of the problem is further evidenced by the fact that the Departmentwide financial statement required **$1.7 trillion** in unsupported adjustments before it could be balanced; **tens of billions** of dollars in "problem" disbursements could not be tracked back to the underlying obligations; and the Department is incapable of accurately reconciling its accounts with the Department of the Treasury account— by a difference of **$9.6 billion**.

Still further, the Department cannot ensure that it has an accurate accounting of its debt obligations. The Air Force found that approximately **$4.3 billion** in obligations in its general funds were incorrect or unsupported. Discrepancies in unsupported obligations at the Army were so serious that the auditors could not quantify the size of the problem.

Defense Department spending may be beyond authorized limits. For example, one of the components of the Air Force may have incurred obligations that exceeded its budgetary allocation by as much as $1.1 billion. Conversely, financial systems do not provide the Department with accurate information on unobligated funds. As a result, the Department concluded this past fiscal year with $4.3 billion in authorized budget funds that expired and went unused. These types of problems leave the Department open to serious waste, fraud, and abuse.

Financial problems can affect the Department's ability to operate effectively. The Defense Department owns over $1 trillion in weapons systems, inventory, and equipment. The Department's inability to account for its assets affects its capability to manage this property, including its weapons systems.

The logistical systems responsible for tracking these assets lack the sophistication to determine accurately what is owned, to safeguard property from deterioration, or to prevent redundant purchases. This reality is evidenced by the fact that, as part of its fiscal year 1998 audit, the Army determined that as many as 53 reconnaissance aircraft, 81 Tow missile launchers, and 174 command-launch units were not included in the Army's computer system designed for tracking Army equipment.

I have highlighted a few of the most serious problems uncovered by the 1998 financial audits. Despite the challenges, the Department of Defense is a "can-do" organization, and I believe that the Department is committed to modernizing and streamlining its financial management systems and is giving this effort the high-level attention that it deserves.

I look forward to the testimony and thank the witnesses for being here today.

Mr. HORN. We will have it filed for the record as if read. We're delighted to see our colleague this morning. It's sort of a quiet day around here, but that will change as the morning goes on.

So, if you will stand with the people that will also give answers behind you, I want everybody sworn in at once. Just raise your right hands.

[Witnesses sworn.]

Mr. HORN. We have seven witnesses or potential witnesses.

We will start with Mr. Donald Mancuso, the Acting Inspector General, Department of Defense. Mr. Mancuso is accompanied by Mr. Robert Lieberman, Assistant Inspector General for Audit, Department of Defense.

So, Mr. Mancuso, go ahead.

STATEMENTS OF DONALD MANCUSO, ACTING INSPECTOR GENERAL, DEPARTMENT OF DEFENSE, ACCOMPANIED BY ROBERT LIEBERMAN, ASSISTANT INSPECTOR GENERAL FOR AUDIT, DEPARTMENT OF DEFENSE; GENE DODARO, ASSISTANT COMPTROLLER GENERAL FOR ACCOUNTING AND INFORMATION MANAGEMENT, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LISA JACOBSON, DIRECTOR OF DEFENSE AUDITS, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION; AND WILLIAM LYNN, UNDER SECRETARY OF DEFENSE, CHIEF FINANCIAL OFFICER, DEPARTMENT OF DEFENSE, ACCOMPANIED BY NELSON TOYE, DEPUTY CHIEF FINANCIAL OFFICER, DEPARTMENT OF DEFENSE

Mr. MANCUSO. Thank you. Mr. Chairman and members of the committee, I appreciate the opportunity to be here today, to discuss the significant challenges facing the Department of Defense in the financial management area and the progress made since your last hearing on these matters just over a year ago.

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 Department of Defense. The Department is the largest holder of U.S. Government physical assets, has the most employees, 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 end of the cold war and the downsizing of the Defense budget caused many profound changes in the Department. For example, it was evident that administrative processes of all kinds, including finance and accounting, in their current forms were neither affordable nor capable of keeping pace with rapidly changing management practices and information technology.

Likewise, individual DOD components have been allowed to develop several hundred finance and accounting automated systems, whose interoperability among themselves and with nonfinancial systems was generally poor.

In my office's estimation, achieving full integration of DOD support operations, including financial management, is far from complete. It will require sustained and probably even intensified commitment by both the Congress and the Department and will certainly take several more years.

The Department has not been able to comply with the requirements for automated financial statements levied by the Chief Financial Officers Act, the Government Management Reform Act, and the Federal Finance Management Improvement Act. The results of the audits of the DOD financial statements for fiscal year 1998, when viewed solely in terms of audit opinions, were identical to the previous poor results.

My office and the Auditors General of the Army, Navy and Air Force issued opinion reports earlier this year. Only the Military Retirement Trust Fund received an unqualified clean audit opinion. Disclaimers of opinion were necessary for the consolidated DOD statements, as well as all other major fund statements.

The Department lacks systems capable of compiling financial reports that comply with Federal accounting standards and laws, nor will those systems be in place for several more years. Much effort is being expended, however, to compensate for inadequate systems and to achieve improvement. It is likely that one or more of the major fund entities below the DOD level will achieve a clean or unqualified opinion during the next 1 to 3 years and various smaller entities are likely to do so as well.

Although such indicators of progress may be good for morale, favorable opinions on fragments of the Department's financial reports have limited actual importance if the consolidated statements remain fundamentally flawed. The prospect for favorable audit opinions on the consolidated DOD financial statements in the near term are not good.

We believe that focusing on audit opinions as the primary indicator of financial management and improvement may well incentivize some Federal managers merely to want to shop around for favorable audit opinions on annual statements, instead of focusing on the usefulness of all financial reports and the adequacy of management controls.

An agency could conceivably develop workaround procedures, actually bypassing its official accounting systems, that would function well enough to achieve a favorable audit opinion on its consolidated financial statements.

Unfortunately, failure to fix those systems and related control weaknesses would leave program managers still unable to rely on the various financial reports that they need to conduct day-to-day business. Several other sources of insight into the Department's progress should be considered in addition to audit opinions.

First, the previously mentioned extensive audit reporting provides considerable information. Second, numerous action-plan milestones have been created in an effort begun in mid-1998 by the Office of Management and Budget, the General Accounting Office, the DOD Chief Financial Officer and my staff to develop sound action plans for implementing the new Federal accounting standards.

Third, progress toward making financial and nonfinancial feeder systems compliant with applicable laws, regulations and new accounting standards is an excellent indicator of how well the system deficiencies that are the root cause of inaccurate financial reporting are being addressed.

We recently issued a report that assessed the Biennial Financial Management Improvement Plan whose first version was provided

by DOD to Congress last September as a response to a tasking in the National Defense Authorization Act for fiscal year 1998. We concluded that the plan's focus on systems was very appropriate, although much can be done to improve it as a reporting vehicle to the Congress.

Another major step would be to develop more effective internal DOD management mechanisms. It is useful to compare the well-focused reporting now being regularly provided to senior managers and Congress on the Y2K compliance status of several thousand DOD systems with the rather unfocused information available annually on the CFO compliance status of about 200 of those same systems.

As you know, the DOD struggled at first with the year 2000 conversion, because definitions of terms like "compliant" and "certified" were unclear, but there was insufficient management control of the overall program; and many functional managers and commanders initially remained uninvolved. So far the same kinds of problems have hampered the financial management system improvement effort.

We look forward to helping the Department learn from the Y2K experience and establish an approach that will allow senior managers and Congress to know exactly how well each DOD management sector is supporting the DOD system improvement goals.

Mr. Chairman, my written statement discusses several other challenges confronting the DOD financial community in addition to financial reporting. I would, however, like to emphasize my concern about information assurance. As the recent hacker attack against the NATO website and the so-called Melissa virus incident demonstrated, any automated system may be attacked or misused.

My office has been working closely with the Defense Information Systems Agency and the Defense Finance and Accounting Service over the past several years to address this problem. We have issued 20 audit reports during the 1990's on security matters related to DFAS and made over 200 recommendations.

The Defense Criminal Investigative Service, the investigative arm of our office, recently established an information infrastructure team. This new unit works in partnership with other law enforcement organizations and the Defense Information Systems Agency to react immediately to system penetration incidents involving any part of the Department. Additionally, we have a special agent assigned full-time to the FBI National Infrastructure Protection Center.

Knowing this subcommittee's leading role in monitoring efforts to combat the so-called millennium bug, I also want to emphasize we've been auditing the DFAS Y2K conversion problem continuously since mid-1997. DFAS has been responsive to audit advice and has made great progress in ensuring that its 41 mission-critical systems will be able to function; however, much remains to be done.

Of those, 13 systems missed the OMB compliance goal of March 31, 1999; and DFAS still faces formidable challenges in terms of ensuring robust end-to-end testing and formulating realistic contingency plans.

In summary, the DOD financial management community faces major challenges and needs the active support of senior departmental managers and the Congress. My office will continue to place heavy emphasis on DOD finance and accounting operations. We'll be keeping all stakeholders, the Department, Congress, OMB, and the public informed of our audit and investigative results. Thank you.

Mr. HORN. Thank you. You actually have 3 minutes to go. So thanks for the rapid summary, it was very good.

[The prepared statement of Mr. Mancuso follows:]

Hold for Release
Until Delivery
Expected 10:00 a.m.
May 4, 1999

Statement by

Mr. Donald Mancuso

Deputy Inspector General

Department of Defense

Before the

Subcommittee on Government Management,

Information and Technology,

House Government Reform Committee,

on

Defense Financial Management

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss the significant challenges facing the Department of Defense (DoD) in the financial management area and the progress made since your last hearing on these matters, just over a year ago.

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 ($1.3 trillion), has the most employees (2.2 million), owns the most automated systems (28,000), 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 making 9 million personnel payments; processing 2 million commercial invoices; paying 675,000 travel settlements; issuing 550,000 savings bonds; handling 340,000 transportation bills of lading; disbursing $22.2 billion; and reporting commitments,

obligations, expenditures and other data for many thousands of accounts.

A Decade of Change

The end of the Cold War and the downsizing of the Defense budget in the early 1990's caused many profound changes in the DoD. For example, it was evident that administrative processes of all kinds, including finance and accounting, in their current forms were neither affordable nor capable of keeping pace with rapidly changing management practices and information technology. Likewise, the individual DoD components had been allowed to develop several hundred finance and accounting automated systems, whose interoperability among themselves and with non-financial systems was generally poor. To begin turning this situation around, the decision was made to centralize those operations and systems in the Defense Finance and Accounting Service (DFAS), which was activated in January 1991. Along with all other DoD functional communities, the financial management activities began a long term effort to reengineer their own processes, participate in the reinvention of other DoD processes, and develop a new generation of modern and interoperable information systems.

In my office's estimation, achieving full integration of DoD support operations, including financial management, is far from complete, will require sustained and probably even intensified commitment by both the Congress and the Department, and will certainly take several more years.

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

- the Chief Financial Officers (CFO) Act of 1990 and related subsequent legislation that introduced commercial type financial reporting requirements, for which DoD was entirely unprepared;

- the dramatic expansion of financial statement auditing, which was mandated by the CFO Act and drove DoD financial audit coverage from one or two dozen workyears in 1989 to over 600 in 1998; and

- the consolidation of many inefficient and outmoded finance and accounting practices into one customer funded organization, DFAS, where those inefficiencies

were far more visible and customer dissatisfaction was more focused.

Financial Reporting

The DoD has not been able to comply with the requirements for audited financial statements levied by the Chief Financial Officers (CFO) Act of 1990, the Government Management Reform Act of 1994 and the Federal Financial Management Improvement Act of 1996. Its accounting systems were designed mostly for funds control, not financial statement reporting. Those systems lack integrated, double-entry, transaction-driven general ledgers. They cannot produce an audit trail from the occurrence of a transaction, through recognition in accounting records, until incorporation into financial statement data. There are numerous internal control problems in the accounting systems and the non-financial "feeder" systems, which are operated by the acquisition, logistics and other program management communities and provide 80 percent of the financial statement data. These and other fundamental problems have been repeatedly and candidly acknowledged in DoD management representation letters, annual Secretary of Defense management control assessments and congressional hearings, including those held by this subcommittee.

The financial reporting challenges also include: the steady stream of expanded statutory requirements, new and still evolving Federal Accounting Standards Advisory Board (FASAB) principles, the Administration's goal of unqualified audit opinions on the Government-wide Consolidated Statements for Fiscal Year 1999, and increasingly detailed Office of Management and Budget (OMB) guidance. Each of these has generated very significant new workload requirements for the managers who are trying to make systems "CFO compliant," for the preparers of financial statements, and for the auditors. Because of FASAB and OMB guidance, the number of statements for each reporting entity jumped from 3 for FY 1997 to as many as 8 for FY 1998. The DoD prepared and we audited financial statements for 11 reporting entities in FY 1998; no other Federal agency had more than four reporting entities, and many had just one. Currently, we are working with the Under Secretary of Defense (Comptroller) to reconsider the number of separate DoD reporting entities, so that the statement preparation and audit workload can be kept within reasonable bounds.

The results of the audits of the DoD financial statements for FY 1998, when viewed solely in terms of audit opinions, were identical to the previous poor results. My office and the

Auditors General of the Army, Navy and Air Force issued opinion reports earlier this year. Only the Military Retirement Trust Fund received an unqualified "clean" audit opinion. Disclaimers of opinion were necessary for the consolidated DoD statements, as well as all other major fund statements.

The DoD continues to lack systems capable of compiling financial reports that comply with Federal accounting standards and laws, nor will those systems be in place for several more years. Likewise, the labor intensive workarounds currently being used to formulate the annual statements are fundamentally ineffective, but will not be replaced until more efficient automated approaches are feasible. This year, partially because of the significantly increased workload and complexity related to the new financial statement preparation requirements, DoD final statements were more untimely than ever. In addition, a record $1.7 trillion of unsupported adjustments were made in preparing the statements. In addition to 11 opinion reports, the DoD audit community detailed the Department's progress and continuing deficiencies in 178 other financial audit reports issued between April 1, 1998 and March 31, 1999. Examples are summarized in the attachment to this statement.

Much effort is being expended to compensate for inadequate systems and to achieve improvement. It is fairly likely that one or more of the major fund entities below the DoD level will achieve clean or qualified opinions during the next one to three years, and various smaller entities are quite likely to do so as well. Although such indicators of progress may be good for morale, favorable opinions on fragments of the Department's financial reports have very limited actual importance if the consolidated statements remain fundamentally flawed. The prospects for favorable audit opinions on the consolidated DoD financial statements in the near term are not good.

Measuring Progress

We believe that focusing on audit opinions as the primary indicator of financial management improvement may well incentivize some Federal managers merely to want to shop around for favorable audit opinions on annual statements, instead of focusing on the usefulness of all financial reports and the adequacy of management controls. An agency could conceivably develop workaround procedures, actually bypassing its official accounting systems, that would function well enough to achieve a favorable audit opinion on its consolidated financial statements. Unfortunately, failure to fix those accounting

systems and related control weaknesses would leave program managers still unable to rely on the various financial reports that they need to conduct day to day business. We would consider the achievement of favorable audit opinions on annual financial statements, under those circumstances, to be a Pyrrhic victory.

Several other sources of insight into the Department's progress should be considered in addition to audit opinions. First, the previously mentioned extensive audit reporting provides considerable information. These reports are far from being carbon copies of each other. Because their sheer number can appear overwhelming, we will continue our past practice of issuing annual summary reports that highlight major deficiencies preventing favorable audit opinions on DoD financial statements. We are currently compiling the summary report addressing the statements for FY 1998 and will issue it this summer.

Second, numerous action plan milestones have been created in the effort begun by the Office of Management and Budget, General Accounting Office, DoD Chief Financial Officer and my staff in mid-1998 to develop sound action plans for implementing the new Federal accounting standards. Although not all issues on how to interpret and implement the standards have been resolved, the

degree of consensus is much broader now than ever before. Progress toward meeting the agreed-upon implementation milestones can be tracked and we intend to do so closely.

Third, progress toward making financial and non-financial feeder systems compliant with applicable laws, regulations and new accounting standards is an excellent indicator of how well the system deficiencies that are the root cause of inaccurate financial reporting are being addressed. The Federal Financial Management Improvement Act of 1996 and the National Defense Authorization Act for FY 1998 focused on system improvement. The latter Act added a new section to Title 10 that required detailed reporting on system status in a DoD Biennial Financial Management Improvement Plan.

Biennial Plan

My office published an extensive evaluation of the September 1998 version of the DoD Biennial Financial Management Improvement Plan on April 2, 1999. We concluded that DoD had made a valid first attempt to compile the extensive data required by law. We strongly support the DoD concept of folding all data required on financial management system status by the Federal Managers Financial Integrity Act of 1982, the Chief

Financial Officers Act of 1990, the Federal Financial Management Improvement Act of 1996, and the National Defense Authorization Act of 1998 into one publication, the Biennial Plan. We understand that the Department intends to update the Biennial Plan annually, which will facilitate that consolidation.

Our report also indicated numerous areas where the first version of the Biennial Plan could be improved, both to comply with the variety of statutory requirements it is intended to address and to become a good tool for managing the financial management systems development effort in an intensive and fully integrated way. In addition to ensuring that the next version includes vital data like interim milestone dates for systems being developed or modified to attain compliance, for example, we recommended taking a major step toward establishing management control over the whole process by requiring written agreements between DFAS and owners of non-financial feeder systems.

Another major step would be to develop more effective management oversight mechanisms. It is useful to compare the well focused reporting now being provided to senior managers and Congress on the Y2K compliance status of several thousand DoD systems with the rather unfocused information available on the CFO compliance status of about 200 of the same systems. As you know, the DoD

struggled at first with the Year 2000 conversion because definitions of terms like "compliant" and "certified" were unclear, there was insufficient management control of the overall program and many functional managers and commanders initially remained uninvolved. So far, the same kinds of problems have hampered the financial management system improvement effort. We are pleased, therefore, that the Under Secretary of Defense (Comptroller) data call for the next Biennial Plan implemented most of our recommendations. We look forward to helping the Department learn from the Y2K experience and establish a systems management approach that will allow senior managers and Congress to know exactly how well each DoD management sector is supporting the DoD system improvement goals.

Once a viable status reporting process is established, updates should be provided as a management tool for the Defense Management Council, other oversight groups, DoD Chief Financial Officer, DoD Chief Information Officer, and senior managers who "own" feeder systems. This information should be reviewed much more frequently than annually. We suggest, in other words, that the Biennial Plan be used as a catalyst for more visible, accountable and effective management of the financial management systems improvement effort. Just as Y2K conversion is not a

problem that information technologists can solve alone, so too is "CFO compliance" not a goal that DoD accountants can achieve without a strong commitment from the rest of the Department.

Systems Security

Turning to other challenges confronting the DoD financial community, I would like to emphasize my concern about information assurance. As the recent hacker attack against the NATO website and the so-called Melissa Virus incident demonstrated, any automated system may be attacked or misused. Motives can include vandalism, sabotage, thrill seeking, propaganda, pranks, invasion of privacy and fraud. DoD financial systems that process tens of millions of disbursements worth nearly $300 billion annually are clearly at risk for individuals with any of those motives.

My office has been working closely with the Defense Information Systems Agency and the DFAS over the past several years to address this problem. Fortunately, one byproduct of DoD efforts to reduce the number of separate financial management systems will be somewhat reduced exposure from a security standpoint. To minimize risk, however, it is imperative that security awareness be stressed, adequate training be provided, periodic

security audits be performed for every system and processing center, and prudent measures be taken to detect, react to and learn from unauthorized intrusions.

We have issued 20 audit reports during the 1990's on security matters related to DFAS systems and about 185 of our 220 recommendations to address weaknesses have been implemented. Most of the others were made just recently and actions are either planned or still ongoing. As demonstrated by those numbers, the Department has been quite responsive to audit advice.

The Defense Criminal Investigative Service, the investigative arm of my office, recently established an Information Infrastructure Team. This new unit works in partnership with other law enforcement organizations and DISA to react immediately to system penetration incidents. Additionally, we have a special agent assigned full time to the FBI National Infrastructure Protection Center.

Year 2000 Conversion

During FYs 1998 and 1999, supporting the DoD efforts to avoid mission disruptions because of the so-called Millenium Bug has

been my office's top discretionary audit priority. As part of the coverage provided in all DoD functional areas, we have been auditing the DFAS "Y2K" conversion program continuously since mid-1997. DFAS has been responsive to audit advice and has made progress in ensuring that its 41 mission-critical systems will be able to function; however, much remains to be done. Thirteen of those systems missed the OMB compliance goal of March 31, 1999, and DFAS still faces formidable challenges in terms of ensuring robust end to end testing of its systems, coping with the varying degrees of Y2K readiness of non-financial systems that are linked to DFAS systems, coordinating with the Defense computing centers to assure Y2K compliance of the mainframe computer platforms on which DFAS depends, and formulating realistic contingency plans.

At the present time, absent any end to end test results, it is somewhat premature to make forecasts about Y2K outcomes. I can report to you, however, that DFAS has taken the Y2K challenge very seriously and has been one of the more innovative and aggressive DoD organizations in terms of contingency planning and coordination with public and private sector data exchange partners. The Deputy Secretary of Defense has made it very clear that DoD intends to meet January 2000 payrolls. Recently, OMB directed special emphasis on military retirement pay

processes to demonstrate Y2K readiness. It is also important, of course, to avoid disruptions in payments to suppliers and to financial reporting, including the DoD financial statements for FY 1999.

Vulnerability to Fraud

Numerous factors have contributed to the vulnerability to fraud of DoD finance operations. Those factors have included a weak internal control environment, staff turbulence and lack of sufficient fraud awareness training for finance personnel. Congressional hearings in September 1998 before the Senate Committee on the Judiciary graphically identified control weaknesses and the damage done by a few unscrupulous individuals who exploited those weaknesses.

The DCIS has primary investigative jurisdiction concerning allegations of fraud that directly impact the DFAS, including fraudulent conduct by contractors and government employees. The Military Criminal Investigative Organizations have primary investigative jurisdiction concerning allegations of fraud pertaining to DFAS services provided at individual military installations, as well as pay, allowance and travel fraud committed by a civilian employee or Service member of a Military

Department. DCIS currently has 84 open investigations involving DFAS, 21 of which are theft or embezzlement cases. DCIS efforts over the past 5 years have resulted in 73 convictions and recovery of $4.9 million from cases related to DFAS operations. Examples of recently closed cases are in the attachment to this statement.

We have been working with DFAS to improve the capability to detect fraud in DoD finance operations. Since 1994, OIG, DoD, auditors and investigators have supported Operation Mongoose, a Deputy Secretary of Defense initiative involving the use of computer matching techniques to detect fraud. Problems with data base accuracy have been an inhibiting factor; however, the project has been a useful laboratory for determining the viability of various matches as internal controls and fraud detection tools.

More recently, DCIS has conducted over 60 fraud awareness briefings for DFAS personnel, reaching audiences of about 6,500 employees and including participation in a DFAS stand down day for such training last year. We are working with DFAS on new training initiatives specifically addressing vulnerability in the vendor pay area and on improving fraud referral procedures.

DFAS Management Controls

The key to preventing fraud, waste and mismanagement in DoD finance operations is improving management controls. Although the DFAS candidly reports more material management control weaknesses in its annual assurance statements than any other DoD component, those disclosures are driven by external audit findings, not internal self-assessment. The enormous workload involved in mandatory financial statement audits has shifted my office's audit coverage almost entirely away from the finance side of DFAS--where payments are made--to the accounting side. If our coverage priorities were driven solely by risk assessment, we would earmark about 50 auditor workyears annually for intensive review of internal controls in DFAS personnel and contractor pay operations for three to four years, systematically covering all centers and operating locations.

The initial organizational plan for DFAS included provision for a strong Office of Internal Review. Pressures to reduce personnel strength and overhead costs, as well as lack of sustained management emphasis, have prevented the DFAS Office of Internal Review from becoming a meaningful factor in the DFAS management control structure. Lacking sufficient coverage of its most high risk operations from either external or internal

auditors, DFAS will remain vulnerable to fraud and other problems in those operations, despite the recent commendable initiatives on fraud awareness.

Problem Disbursements

To maintain proper fiscal control and have reliable information on amounts available for obligation and expenditure, DoD needs to be able to match disbursements reported to the U.S. Treasury with obligations shown in DoD accounting records. Unfortunately, the disbursing and accounting functions are performed by separate activities, which are not linked in fully integrated systems and often are not collocated. Disbursement data therefore must "transit" to the accounting stations. Excessive delays and errors can occur in recording the disbursements in the accounting systems. DFAS uses the term "aged intransit disbursements" to denote excessive delays. If attempts to match disbursement and obligation data fail, the term "problem disbursements" is used.

The DoD has been working to reduce aged intransit and problem disbursements for several years. DFAS reported a decrease in aged intransit disbursements from $22.9 billion in June 1997 to $9.6 billion in June 1998. DFAS also reported a reduction in

problem disbursements from $34.3 billion in June 1993 to $11.1 billion in June 1998. Despite those significant decreases, unmatched disbursements will remain a DoD financial management challenge until fully integrated systems are fielded and the backlog of unmatched disbursements is eventually eliminated. Until then, the Department must make the best of a bad situation and try to minimize its exposure to Antideficiency Act violations and undetected improper payments.

We recently completed an audit of the reporting for aged intransit disbursements and problem disbursements between June 1996 and June 1998. The audit indicated that, while there continued to be overall progress, some DoD components were actually losing ground and the unmatched disbursements in their accounts were increasing. Efforts to match pending disbursements to corresponding obligations before making payments, commonly referred to as "prevalidating disbursements," have been only partially implemented because significant payment delays were encountered when trying to prevalidate all disbursements over $2,500 at DFAS Columbus Center. In addition, DFAS needs to improve the accuracy of its reports to senior managers and the Comptroller needs to decide whether to enforce his policy that currently available funds must be obligated to cover certain aged intransit and problem disbursements. Not to

do so increases the risk of Antideficiency Act violations, which carry potential criminal penalties. Obligating funds to cover these accounting problems, on the other hand, ties up 2 to 3 billion dollars that are urgently needed for other purposes and therefore some Services and Defense agencies are resistant to the policy. This seemingly arcane accounting issue has very real program impact.

Other Contractor Pay Issues

During the past year, the Department has stepped up efforts to assure appropriation integrity when making progress payments to contractors; encourage managers not to add to the accounting burden by creating unnecessary extra accounts; and introduce mass use of credit cards for purchasing goods and services. These significant initiatives are still new and there has been little feedback on how they are progressing. We have not had sufficient audit resources available recently to provide an independent evaluation. We continue to support all four concepts, however, and hope to provide at least some audit coverage later in FY 1999 or 2000.

Summary

The DoD financial management community faces major challenges and needs the active support of senior Departmental managers and the Congress to meet them. The DoD audit and investigative communities understand the importance of achieving the Department's goals in this area and the difficulties involved. We will continue putting heavy emphasis on DoD finance and accounting operations, while keeping all stakeholders--the Department, Congress, OMB and the public--informed of our audit and investigative results. Thank you.

Selected Audit Reports and
Criminal Case summaries

Inspector General, DoD, Audits

Report No. 99-135, Trends and Progress in Reducing Problem Disbursements and In-Transit Disbursements, April 16, 1999. Between June 30, 1996 and June 30, 1998, DFAS reported that problem disbursements decreased by $1.9 billion to $11.1 billion. Aged in-transit disbursements decreased by $13.3 billion, from $22.9 billion to $9.6 billion between June 30, 1997 and June 30 1998. The Navy, the Air Force, and the Marine Corps reported progress in reducing delays in properly matching disbursements to corresponding obligations. However, no progress was made in reducing aged in-transit disbursements and problem disbursements for the Army and some Defense agencies. For those entries, aged in-transit disbursements increased $0.6 billion between June 1997 and June 1998. Because DoD continued to have at least $20.7 billion in disbursements that were not properly recorded in accounting records, financial statements showing the status of budgetary resources were unauditable and may have been materially misstated. Risk of over disbursement and Antideficiency Act violations remained unacceptably high. In addition, there were problems with the accuracy and consistency of data being reported to management.

Report No. 99-128, Computing Security for the Defense Civilian Pay System, April 8, 1999. Because of their sensitive nature, the deficiencies discussed in this report were presented in general terms. The Defense Finance and Accounting Service and Defense Information Systems Agency needed to improve security for the Defense Civilian Pay System and the mainframe computer platforms on which it runs. This was the second in a series of two reports on this subject.

Report No. 99-123, Assessment of the DoD Biennial Financial Management Improvement Plan, April 2, 1999. In the September 1998 Biennial Plan, DoD made a valid attempt to compile and report all the necessary data on financial management systems. The Biennial Plan could be improved if it better identified the deficiencies for each financial management system and disclosed the remedies, resources, and intermediate target dates necessary to bring DoD financial management systems into substantial compliance. The Biennial Plan should also identify an overall milestone date for all financial management systems to achieve full compliance, and should better address the Special Interest Items directly related to financial management systems, as required by the National Defense Authorization Act for FY 1998. The Biennial Plan should also be purged of unsupported opinions that have nothing to do with planned actions to overcome impediments to financial management improvement.

The role of the DoD components other than the Office of the Under Secretary of Defense (Comptroller) in formulating the Biennial Plan was limited, underscoring the need for more emphasis on a fully integrated management approach. The Biennial Plan could be developed into an excellent management tool for controlling and reporting on the status of the financial management systems improvement effort, but all major DoD components need to take an active role in formulating and executing the Biennial Plan.

Report No. 99-097, Internal Controls and Compliance with Laws and Regulations for the DoD Agency-wide Financial Statements for FY 1998, March 1, 1999. Internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulation, and that financial statements were free of material misstatements. The internal controls did not ensure that adjustments to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-wide Financial Statements for FY 1998, the DoD Annual Statement of Assurance for FY 1998, and the DoD Biennial Financial Management Improvement Plan.

Report No. 99-013, Summary Report on Financial Reporting of Government Property in the Custody of Contractors, October 15, 1998. This report summaries the weaknesses identified by a DoD-wide audit performed by the Inspector General, DoD; Army Audit Agency, Naval Audit Service; and Air Force Audit Agency on the financial reporting of Government property in the custody of contractors. The reported amount of Government property in the custody of contractors has remained about $90 billion (acquisition value) over the last 3 fiscal years. Since our review of the Contract Property Management System and the FY 1996 DoD financial statements, financial managers in each Military Department have adjusted the way data from the Contract Property Management System are used for financial reporting. However, the system and the way the data are entered into financial statements have not changed. The DoD financial statements for FYs 1996 and 1997 did not accurately report Government property in the custody of contractors. Although the Contract Property Management System does report Government property, financial statement requirements are not met because the system: does not apply capitalization thresholds; does not compute depreciation; does not distinguish between assets of the General Fund and the Working Capital Fund; and does not provide data in time to meet financial statement reporting milestones. The amount of Government property in the custody of contractors remains material to the DoD financial statements, and the National Defense line on the Government-wide financial statements is material to the Consolidated Financial Statements of the United States. The inability of DoD to resolve the reporting of Government property in the custody of contractors

will impede the ability of the DoD and the Federal Government to obtain a favorable opinion on future financial statements.

Report No. 99-028, Major Deficiencies Preventing Favorable Audit Opinions on the FY 1997 DoD Financial Statements, October 30, 1998. Auditors identified and DoD financial managers acknowledged major deficiencies that prevented favorable audit opinions on most FY 1997 DoD Financial Statements. The overarching deficiency continued to be the lack of adequate accounting systems for compiling accurate and reliable financial data. Specifically, auditors were unable to render favorable audit opinions on the FY 1997 DoD Consolidated Financial Statements and supporting financial statements prepared for nearly all reporting entities. The reasons were deficient accounting systems, insufficient audit trails, delays in providing auditors with final versions of the financial statements and management and legal representation letters, lack of effective internal management controls, and the consequent scope limitations that prevented auditors from auditing material lines on the DoD financial statements. Except for the unqualified audit opinions rendered on the DoD Military Retirement Trust Fund Financial Statements, which accounted for 10.8 percent of DoD Consolidated assets and 4.4 percent of DoD Consolidated revenues in FY 1997, auditors have been disclaiming opinions on major DoD financial statements since FY 1988.

In response DoD financial managers have acknowledged significant problems with financial data and have been attempting to correct the problems. This report identifies numerous corrective actions taken and ongoing initiatives. Although DoD continues to evaluate its options for achieving adequate and compliant DoD accounting systems, progress in correcting deficiencies in accounting systems has been slow and has had mixed results. For example, DoD completed deployment of a new accounting system, the Corps of Engineers Financial Management System, throughout the U.S. Army Corps of Engineers. However, the Defense Property Accountability System, which was proposed as the answer to unreliable reporting of DoD real and personal property, has fallen short of expectations. Until DoD deploys accounting systems that comply with the Federal Financial Management Improvement Act of 1996, auditors will not be able to perform sufficient tests on material financial statement line items to warrant favorable audit opinions on the DoD financial statements.

Defense Criminal Investigative Services Cases

Air Force Staff Sergeant Robert L. Miller, Jr., was convicted and sentenced by a general courts-martial to 12 years in prison, a dishonorable discharge, reduction in rank to E-1 and forfeiture of all pay and allowances. This was a result of Miller's theft of 17 U.S. Treasury Checks totaling $436,684 and attempted theft of 2 checks totaling $501,851, from the DFAS,

Dayton, Ohio, where he was assigned. Miller caused bogus U.S. Treasury checks to be issued to Payling Scott, of Atwater, California, a co-conspirator, who cashed the checks, kept a portion of the funds for herself and sent the remainder to Miller. Scott pled guilty to conspiracy and was sentenced to 3 years probation and ordered to make restitution for her portion of the stolen funds. This investigation was worked jointly by DCIS and AFOSI.

Teasa Hutchins, Jr., Fort Myer, Virginia, pled guilty to theft of Government funds and was sentenced to 21 months incarceration and ordered to pay $168,772 restitution. Hutchins, a former pay supervisor in the Finance and Accounting Office, Military District of Washington, embezzled approximately $169,000 by establishing an account in the name of a fictitious military member. Hutchins used the ghost account to effect electronic funds transfers to bank accounts owned or controlled by Hutchins and a civilian acquaintance. This investigation was worked jointly by DCIS and the Army Criminal Investigation Command.

Argent Research & Recovery, Limited (Argent), Weymouth, Massachusetts, was sentenced to 12 months probation. Mathew M. Drohan, executive vice president, was sentenced to 48 months incarceration. Argent and Drohan were jointly ordered to make restitution in the amount of $2,127,481. Raymond J. Keegan, Plymouth, Massachusetts, former president and co-owner of Argent, pled guilty to two counts of Federal income tax evasion and was sentenced to 11 months incarceration, 24 months probation and ordered to pay a $3,100 fine. Argent had been engaged in the business of identifying Federal, state and local government funds that had not been received by the payees, and collected the funds for a percentage of the proceeds. Both Argent and Drohan were embezzling funds collected from DFAS on behalf of payees. Keegan failed to report income derived from criminal activity

Investigation disclosed that checks stolen from DFAS, Columbus, Ohio, by a former employee were deposited into fraudulent business accounts at several banks. Funds were then withdrawn by co-conspirators using false identification. To date, nine subjects have been convicted and sentenced to incarceration totaling over 103 months, with monetary recoveries of $246,000. The longest sentence was meted out to Richard E. Watkins, Columbus, Ohio, who pled guilty to conspiracy to commit bank fraud and was sentenced to 37 months incarceration and ordered to pay $10,000 restitution.

Sonya R. Fernandez, Santa Ana, California, pled guilty to theft, embezzlement and submitting false statements and was sentenced to 24 months confinement and ordered to pay $269,488 restitution. Investigation disclosed that Fernandez failed to notify the Government for 10 years of the 1987 death of her adoptive father and continued to receive Federal retirement

benefits destined for him. DFAS paid over $97,000 of retirement benefits that Fernandez illegally converted to her own use.

Mark J. Krenik, an Air Force Contracting Officer's Technical Representative, at Reese Air Force Base, Texas, created false invoices for automated data processing equipment. Due to downsizing of his office, he became responsible for generating the requirements, placing the orders, certifying delivery, and authorizing payments. He opened two accounts at a local bank under a fictitious business name and placed himself as sole signature authority on the accounts. Eleven Government checks totaling $505,941 were deposited to the accounts. The bank notified Federal authorities. Krenik was found guilty of three counts of filing false claims, received three years probation, was fined and ordered to pay restitution. The entire $505,941 deposited to the accounts was recovered. Krenik was able to accomplish his crime because of little or no oversight on the contracts in which he was involved. Consolidation of responsibilities of three staff positions and violating the internal control principle of separation of duties allowed the opportunity for Krenik to develop the scheme to defraud the Government.

Mr. HORN. We now deal with the General Accounting Office, Mr. Gene Dodaro, the Assistant Comptroller General for Accounting and Information Management. He is accompanied by Ms. Lisa Jacobson, the Director of Defense Audits, same division.

Mr. Dodaro.

Mr. DODARO. Thank you, Mr. Chairman. Good morning to you, Congressman Turner, Congressman Ose. We appreciate the opportunity to be here today to talk about the need to strengthen financial management at the Department of Defense.

A few weeks ago, I was before this committee and we were talking about the major challenges confronting the Federal Government in receiving a positive opinion on the consolidated statements of the Federal Government. DOD represents a significant portion of its assets and liabilities. And, indeed, over half of all discretionary spending of the Federal Government. Addressing the financial management weaknesses at the Department of Defense is an integral part of achieving the administration's goal of having an unqualified or clean opinion on the financial report of the entire Federal Government.

Equally as important, however, if not more critical, is the need to strengthen financial management at the Department to better demonstrate accountability over billions of taxpayer dollars and also to provide more reliable and timely information in order to manage the Department's vast operations more efficiently. The Department recognizes these potential benefits, and I'm pleased to report this year that they've accelerated their efforts to address these problems that have been plaguing them for a number of years.

But we also need to recognize that these problems are pervasive. They're serious, and they need to be corrected in a very large decentralized organization. As a result, it's going to take time. It's going to take a lot of effort, and it will take dedicated top-level attention in the Department similar to, as Mr. Mancuso mentioned, the effort being put forward on the year 2000 problem, to really make some progress.

Now, while the challenges are great at improving financial management at DOD, so are the potential benefits. No. 1, improving financial management over at the Department of Defense would help address known inefficiencies that are draining resources away from readiness and other priorities, such as modernizing weapons systems.

For example, it's widely recognized that problems in having adequate visibility over assets has led to greatly increased costs of military operations such as Desert Storm.

It's also well known and well documented that inventories are incomplete and not accurate at the Department and, as a result, this is a contributing factor to hundreds of millions of dollars in uneconomical purchases and also has an impact on readiness.

Also good financial management information is really a critical foundation to identifying and implementing other management reforms. For example, questions have been raised about the cost savings occurring from base closures because of the lack of good historical data at the Department.

Now, when we look at this, we always see that savings indeed happen, but the timing of when the savings occur and the exact

amount to be saved always do not come to pass because of the difficulty in making the estimates. Also when the Department compares its internal operations to those of the private sector in arriving at decisions on outsourcing options, it's difficult to make a decision if you're a Department manager on what's the most economical option to pursue because there's not good historical information on the costs of their operations.

And it is also well recognized within the Department that the cost accounting systems to track life-cycle costs of weapon systems are not what they need to be, and they need to be improved. Third, there's a need to make sure there's better financial management to track the status of budget resources.

There was approximately over $9 billion of differences this past year between DOD's records and the Department of Treasury's records. And you can well imagine what the significance of that would be if you're trying to balance your own checkbook with that of a bank. And, indeed, not balancing results in some difficulties. For example, during the 1998 audit, the auditors came across a deposit that the Army had made in 1991, 7 years earlier, that was supposed to be an over $2 million deposit in the bank. Well, the bank, because of an error, only recorded that deposit at less than $3,500.

So until the reconciliations got started, this went undetected for a 7-year period. Once it was discovered, the bank repaid the Federal Government the $2.1 million plus $640,000 of interest; but during that 7-year period, the government was deprived of this money. And as most of you know during many of those years, we were borrowing to fund the general operations of the government. So the need to do these reconcilations is very important.

Also, audits have discovered where sometimes budget authority might lapse. There are budget resources that are encumbered or obligated that may not be deobligated and used for other sources, and in still other instances, there are some concerns whether or not the Department has exceeded budget limits that have been set by the Congress. So this whole area is one where better financial management would lead to sound budget integrity which is one of the key goals of the CFO Act.

Now, the Department recognizes the importance of these problems and this past year has accelerated its effort, put more resources on it. We're having a very constructive dialog, as Mr. Mancuso outlined, coming up with short-term plans, as well as highlighting some of the longer-term issues that need to be dealt with.

Now in the short term, what needs to be done? No. 1, the data in the existing systems the Department is using needs to be better in terms of being cleaned up, and following control procedures that aren't followed. The existing systems could produce better information as the Department focuses on implementing procedures that are in place or making some modifications to those procedures.

Second, accounting standards are in place across the Federal Government. The Department has not yet fully implemented, then for example, in the environmental disposal area. They need to implement those standards; they're working on that. But those need to be put in place and procedures followed. The Department also

needs to balance its checkbook with the Treasury Department. That needs to be cleaned up, because every day billions of dollars are spent.

If these records are not cleaned up from the beginning, they're just going to snowball and have a cumulative effect of never being able to be unraveled over time.

Also the Department needs to have better financial management training for its employees. The requirements for Federal financial management have been increased through the CFO Act and other mandates that the Congress has legislated to achieve financial management reform, but there needs to be commensurate training that for the financial management work force in the Department. We made some recommendations along those lines for minimum training requirements. Training needs to be revamped.

One of the key goals of the CFO Act was to upgrade the qualifications of financial management personnel across the government. That needs to be done in order for these changes to come to fruition. Also in addressing the long term, the Department had a major step this past year in issuing its first biennial financial management improvement plan. That plan was a good start. For the first time DOD recognized that systems, other than just the finance and accounting systems, need to be revamped. Such as logistics systems that are used to track inventories, and property management systems. Indeed, 80 percent of the information to prepare the financial statements comes from outside the financial sphere, and so they need to involve people across the Department.

This plan begins that process. They've also committed to update this plan annually, which is a good step forward. And we've made some recommendations, as they do that, to incorporate more requirements into that plan to make sure that they, indeed, do in the new systems that are developed have—first of all, a smooth transition from the existing systems to their new environment in the future; that they build in requirements to have data integrity in the new systems so you don't just have modern updated systems but still have the data integrity problems because they're not following procedures; and they really need to improve their activities to implement information technology reform, and embody the Clinger, Cohen amendments that the Congress has levied in 1996 to develop IT investments in modular projects to have good cost investment, disciplined processes.

The Department is committed to put in place the requirements of that legislation, but it's yet to fully implement them. That will be very important if the Department is ever going to have modern management systems that will work effectively and produce all the requirements.

In closing, let me commend this committee for its diligent oversight in this area. It's really the series of hearings that have been held over the past few years on DOD financial management that have been very important to helping stimulate and encourage the type of constructive dialog we've had with the Department. And we

look forward to continuing to work with this committee and with DOD in really making financial management reform a day-to-day reality at the Department.

Thank you very much. I would be happy to answer questions after all the witnesses have given their statement.

[The prepared statement of Mr. Dodaro follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Management, Information and Technology, Committee on Government Reform, House of Representatives

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DEPARTMENT OF DEFENSE

Addressing Financial Management Weaknesses Key to Assuring Accountability and Operational Efficiency

Statement of Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division

GAO/T-AIMD/NSIAD-99-171

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss the status of financial management at the Department of Defense (DOD). This discussion is particularly timely in light of our recent report[1] on the fiscal year 1998 Financial Report of the U.S. Government. Material financial management deficiencies identified at DOD, taken together, 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 liabilities, and a net cost of operations of $280 billion in fiscal year 1998—have a tremendous impact on the government's consolidated reporting.

DOD has created and maintains the world's most powerful fighting force and its effectiveness in protecting the safety and security of our nation and national interests is unparalleled. Yet, without more reliable financial and other management information, DOD cannot ensure adequate accountability to the President, the Congress, and the American public. In addition, decisionmakers and managers are deprived of valuable tools to control costs and address pressing management issues that drain resources that could be better used to increase readiness and meet other priorities, such as weapon systems modernization.

While in the past we have questioned the department's commitment to fixing these long-standing problems, DOD has started to devote additional resources to correct its financial management weaknesses. The atmosphere of "business as usual" at DOD has changed to one of marked effort at real reform. DOD is working on short-term actions to improve financial accountability and to help support the President's goal of obtaining an unqualified opinion on the federal government's financial statements. In addition, DOD has recently submitted to the Congress a Biennial Financial Management Improvement Plan. This plan presents, for the first time, the department's strategies, including a concept of operations for modernizing its financial management activities. The plan, which DOD has now committed to updating annually, is an ambitious undertaking that represents an important step toward long-term improvements.

These initiatives are all very important steps in the right direction, but it is essential to keep in mind the magnitude of DOD's financial management problems. These problems are pervasive and entrenched in an extremely large decentralized organization. It will take considerable effort, time, and sustained top management attention to turn reform efforts into day-to-day management reality.

No major part of DOD has 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 operations. 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 our recent high-risk update.[2] The audits of DOD's and individual military services' financial statements for fiscal year 1998 performed by the DOD Inspector General (IG) and the

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[1] Financial Audit 1998 Financial Report of the United States Government (GAO/AIMD-99-130, March 31, 1999).

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

military service audit agencies, as well as our audit of the U.S. government's financial statements, have provided further clarification of the scope and magnitude of the Department's problems, and recommendations to correct them.

My testimony outlines DOD's most serious financial management weaknesses, describes the resulting impact on the department's ability to effectively carry out its programs and operations, and highlights the efforts underway to address these deficiencies. These actions must be implemented effectively for DOD to be able to:

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

Short-term improvement strategies for DOD are imperative. Also, enhancements are needed in updating DOD's Financial Management Improvement Plan—its long-term blueprint for financial management reform.

CONTROL AND ACCOUNTABILITY OVER ASSETS IMPAIRED

As discussed in our recent report on the fiscal year 1998 consolidated financial statements, the federal government--one of the world's largest holders of physical assets--does not have accurate information about the amount of assets held to support its domestic and global operations. DOD primarily relies on various logistical systems to carry out its important stewardship responsibility over an estimated $1 trillion in physical assets, ranging from enormous inventories of ammunition, stockpile materials, and other military items to buildings and facilities to multimillion dollar weapon systems. These logistics 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, as we testified last year,[3] these systems have material weaknesses that, in addition to hampering central visibility and financial reporting, impair DOD's ability to safeguard those assets from physical deterioration, theft, or loss, or to prevent the purchase of assets already on hand in sufficient quantities.

Overall, these weaknesses can seriously diminish the efficiency and economy of the military services' support operations. For example, as noted in our recent report,[4] DOD's lessons-learned

[3] Department of Defense: Financial Audits Highlight Continuing Challenges to Correct Serious Financial Management Problems (GAO/T-AIMD/NSIAD-98-158, April 16, 1998).

[4] Defense Inventory: DOD Could Improve Total Asset Visibility Program With Results Act Framework (GAO/NSIAD-99-40, April 12, 1999).

studies from Operation Desert Storm found that better asset tracking could have saved $2 billion. In response to this problem, the department initiated programs or renewed its emphasis on implementing existing measures that would improve asset visibility and tracking. The Global Combat Support System (GCSS), led by the Defense Information Systems Agency, was established in September 1995 to re-engineer processes and procedures and provide a technological base, including a common environment and shared infrastructure needed to rapidly deploy support to the warfighter. In addition, DOD renewed its Total Asset Visibility (TAV) initiative to provide department-level access to timely, accurate information on the status, location, and movement of units, personnel, equipment and supplies-including weapon systems, secondary inventory,[5] and ammunition. The effectiveness of these programs in achieving their common objectives of supporting the warfighter will depend on the accuracy and timeliness of information provided by the underlying systems.

As discussed in the following sections, because DOD's asset accountability systems and processes remain largely unchanged since last year, audit findings continue to indicate serious weaknesses in controls over inventory; general property, plant and equipment; and national defense assets.

Continuing Control Weaknesses Over Inventory

As part of the fiscal year 1998 financial statement audits, auditors continued to find that DOD's inventory management and control systems and practices are plagued with serious problems that affect its ability to maintain accurate and complete inventory data. DOD inventory[6] includes ammunition (such as machine gun cartridges, rocket motors, and grenades), repairable items (such as navigational computers, landing gear, and hydraulic pumps), consumables (such as clothing, bolts, and medical supplies), and stockpile materials (such as industrial diamonds, rubber, and tungsten). DOD's inability to effectively account for and control its reported $122 billion investment in inventories has been an ongoing area of major concern. Audit findings for fiscal year 1998 include problems in verifying inventory quantities and value, reporting all inventory, and accounting for in-transit inventory. The sheer volume of DOD's on-hand inventories also impedes the Department's efforts to accumulate and report accurate inventory data.

On-hand Quantities Not in Agreement With Records. The Defense Logistic Agency (DLA) distribution depots' inventory records, which account for approximately 75 percent of DOD's reported inventory, supply much of the information for management and financial reporting. Over the years, auditors have repeatedly found problems with the accuracy of DOD's perpetual inventory records, although recent improvements in reported accuracy rates have been noted. For example, for 1996, the DOD IG reported a 24 percent error rate at DOD's primary storage locations[7] and, for 1997, Navy auditors reported a 23 percent error rate for the 13 major storage locations they

[5] Secondary inventory includes spare parts, clothing, and medical supplies to support DOD operating forces worldwide.

[6] Statement of Federal Financial Accounting Standards No. 3 defines several categories of inventory. DOD primarily has inventory held for sale, operating materials and supplies, and stockpile materials. For purposes of this testimony, we refer to all categories as inventory.

[7] Inventory Record Accuracy and Management Controls at the Defense Logistics Agency Distribution Depots (DOD IG Report 98-019, November 10, 1997).

visited.[8] For 1998, preliminary results from Navy auditors' tests showed an improved error rate of 14 percent for the 18 locations visited. Navy officials attributed much of the improvement in inventory record accuracy to extensive rewarehousing—a wall-to-wall physical inventory done to facilitate conversion to a new logistics system. However, preliminary results of tests we conducted for 1998, identified control weaknesses that indicate DOD's reported rates cannot be relied upon to provide a true measure of physical inventory accuracy.

As part of our audit effort for the fiscal year 1998 financial statements, we evaluated DOD procedures for verifying the accuracy of its perpetual inventory records and found significant weaknesses. We have provided our draft report on these issues to DOD officials for their review and comment prior to its release. Although DLA established a record accuracy goal of 95 percent for fiscal year 1998, we found that, at the 14 distributions depots we visited, reported accuracy rates fell below that goal. For fiscal year 1998 counts, only 2 depots had inventory accuracy rates above 90 percent. In addition, several significant control weaknesses in the inventory count process affected the integrity of the counts and these accuracy rates. For example, at all of the depots we visited, counters could access the inventory system to determine the expected number of inventory items on hand. At one depot, we observed counters obtaining system quantities for some of the sample items and recording these amounts as the physical count for the items. When we requested an actual physical count of these items, all had variances. One of the items—night image intensifiers, a controlled item[9] commonly referred to as "night vision goggles" with a unit price of about $1300—had a variance of 1,018 items, which resulted in a $1.3 million loss adjustment to the inventory records.

In addition, at many depots, warehouse personnel—whose duties include storing, rewarehousing, and issuing items—were used to perform inventory counts of these items. Because these warehouse personnel had such dual responsibilities, this arrangement did not ensure adequate segregation of duties. These physical count weaknesses prevented DOD's reported accuracy rates from providing a reliable measure of its record accuracy and, as a result, DOD cannot be assured that (1) inventory it has paid for has been received, (2) inventory is not subject to theft, and (3) inventory balances used to determine requirements reflect all acquired and on-hand quantities.

We also noted that DLA's current sampling methodology could be improved. The sample process used in fiscal year 1998 considered each type of item equally in selecting those to be physically counted. For example, an error for a $1 item was counted the same as an error for a $50,000 item and common hardware items were counted the same as controlled items. In addition, this sample process results in the selection of more items representing insignificant dollar amounts. For example, at one location, an estimated $49.5 million of items were counted out of a total of the reported $4.5 billion of items on hand, accounting for about 1 percent of the total inventory stored there. This type of sampling and the resulting accuracy rates do not give management the opportunity to respond appropriately to errors that reflect more serious problems in accountability

[8] Fiscal Years 1997 and 1996 Consolidated Financial Statements of the Department of the Navy Working Capital Fund Reportable Conditions (NAS 049-98, September 28, 1998).

[9] Controlled inventory items are those designated as having characteristics that require that they be identified, accounted for, secured, segregated, or handled in a special manner to ensure their safeguard or integrity. They include classified, sensitive, and pilferable items.

over high dollar or more sensitive, controlled items. Our draft report on inventory accuracy includes specific recommendations to address the weaknesses identified.

Inventory Values Questionable. Federal accounting standards require inventories to be valued based on historical cost or a method that will approximate historical cost. Further, excess, unserviceable, or obsolete inventory is required to be written down to net realizable value. Valuation at historical cost is particularly important to capture the cost of operations of the supply funds, which are required to recover their inventory and overhead costs through the prices they charge their internal customers. However, DOD values its inventories at standard cost or latest acquisition cost and does not capture the data necessary to value inventory at historical cost.

As a result, DOD developed an agencywide model in 1994 for the purpose of estimating historical cost for inventories. The valuation model uses general ledger data to adjust recorded inventory values to arrive at an estimate of historical costs and to calculate costs of goods sold. However, due to concerns about the accuracy of general ledger data, and weak internal control over the development and operation of the valuation model, auditors have been unable to evaluate the effectiveness of the model, or the estimates of historical cost and cost of goods sold.

Frequent, large adjustments raise concern about the accuracy of general ledger data used in the valuation model. For example, according to DOD IG preliminary results, DOD recorded over $30 billion of individual gain and loss adjustments for fiscal year 1998 to bring the value of inventory in the general ledger into agreement with the value of inventory in the supply activities' logistical records. Most of these adjustments were made without sufficient investigation to determine the underlying causes of differences. Further, to minimize fluctuations in operating results, DOD is reluctant to treat these adjustments as current period gains and losses. However, such treatment does not comply with accounting standards because it defers recognition of gains and losses from activities such as inventory counts, rewarehousing of inventory, and shipping transactions and, therefore, results in a misstatement of inventory and cost of operations.

In addition to concerns about the accuracy of the data used in the model, insufficient controls surrounding the development and operation of the valuation model have resulted in application errors, and further misstatements of reported inventory and cost of goods sold. During 1997, DFAS identified a $3.9 billion error in how the model was applied to Navy's fiscal year 1996 inventory balances, resulting in an understatement in reported inventory by the same amount. In 1998, Navy auditors discovered an error in a 1997 calculation of estimated repair costs that resulted in a $2.3 billion overstatement of reported fiscal year 1997 cost of goods sold. Fiscal year 1998 preliminary audit results indicate that an application error in a reversing entry resulted in an overstatement of Navy's reported inventory of $420 million.

DOD's reported $62.5 billion of operating materials and supplies for fiscal year 1998, including ammunition, were also not valued properly at historical cost, or net realizable value, as required. For example, the Air Force has acknowledged that an estimated $28 billion in operating materials and supplies are inappropriately valued at latest acquisition cost. Army also reported about $20 billion of ammunition at latest acquisition cost and indicated that almost none of this ammunition was excess, unserviceable, or obsolete. Similarly, Navy reported over $11 billion of ammunition without identifying any as excess, unserviceable, or obsolete. However, we have previously

reported that in 1996 about 39 percent of DOD's total ammunition stockpile was excess and that about 27 percent was unserviceable. [10]

Inventories Not Reported. Our report on our audit of the fiscal year 1997 government financial statements disclosed that an estimated $9 billion of known military operating materials and supplies were not reported, including inventories on Army installations, at Navy facilities, and on Navy ships.[11] Similarly, fiscal year 1998 financial statement audit work found that DOD generally excludes information in several inventory accountability systems from financial reports, including reports provided to Congress on inventory levels, and from overall visibility systems. For example, Navy omissions, which primarily relate to spare and repair parts, included an estimated (1) $9 billion in items warehoused onboard ships, (2) $3 billion of inventory items held by engineering and ordnance activities, and (3) $650 million of items at redistribution centers. In addition, an estimated $19 billion of government owned material held by contractors is omitted from inventory reports provided to the Congress. These kinds of omissions adversely affected the Department's financial reporting and its reporting to the Congress on inventory reductions. Further, the lack of complete visibility over inventories increases the risk that responsible inventory item managers may request funds to obtain additional, unnecessary items that may be on-hand but not reported. For example, in February 1997, we reported that DOD had ordered $11.3 million in items such as hydraulic pump valves and circuit card assemblies that were already in excess supply.[12]

In-transit Inventories. The vulnerability of in-transit inventory to waste, fraud, and abuse is another area of concern. Similar to last year's results, auditors were not able to confirm the in-transit inventory, which are included in the reported overall inventory balance on hand. For example, auditors could not determine the reasonableness of almost $600 million of Army's reported inventory in-transit from procurement. In addition, preliminary audit results indicate that the Navy's reported in-transit inventory differed from subsidiary records by about $2 billion and that the Navy had not determined the cause for the difference between the detail records and the reported amount. We also recently testified on Navy's problems with controlling in-transit items.[13] Specifically, we reported that Navy activities were not adhering to control procedures to ensure that in-transit items are accounted for and that responsible commands had not been performing adequate oversight. As a result, the Navy wrote off as lost over $3 billion of in-transit inventory over the last 3 years, including some classified and sensitive items such as aircraft guided-missile launchers, military night vision devices, and communications equipment. This lack of control leaves enormous amounts of inventory at risk of undetected theft or misplacement.

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[10] Defense Ammunition: Significant Problems Left Unattended Will Get Worse (GAO/NSIAD-96-129, June 21, 1996).

[11] Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998).

[12] Defense Logistics: Much of the Inventory Exceeds Current Needs (GAO/NSIAD-97-71, February 28, 1997).

[13] Defense Inventory: Continuing Challenges in Managing Inventories and Avoiding Adverse Operational Effects (GAO/T-NSIAD-99-83, February 25, 1999).

Excess Inventories. The sheer size and volume of DOD's on-hand inventories also impedes the Department's efforts to accumulate and report accurate inventory data. We reported in our January 1999 high-risk report on defense inventory management that the department needs to avoid burdening its supply system with large unneeded inventories.[14] In April 1999, we reported[15] that about 60 percent of on-hand items, or an estimated $39.4 billion of DOD's reported secondary inventory, exceeded DOD's requirements. The DOD IG has also reported[16] that about $3 billion of DLA's reported $9.8 billion of consumable inventory was inactive and of uncertain future utility. As a result, DOD is incurring unneeded inventory holding costs. In 1997, we estimated[17] that the military services could save about $382 million annually in inventory holding costs by eliminating inventory at nonmajor locations that is not needed to meet current requirements. DOD has also acknowledged the need to reduce its inventories and has established goals to reduce supply inventory by $12 billion by 2000.

Short-term Improvements Underway. To begin addressing the inventory accuracy issues raised by financial statement audits, in March 1999, the Principal Deputy Under Secretary of Defense (Acquisition and Technology) directed the military services and the Defense Logistics Agency to evaluate how all transactions impacting inventory are processed into financial management systems, determine the sources and causes of processing errors, and develop a remedial plan for correcting those errors. The military services and DLA are tasked with ensuring that changes and corrective actions are implemented by September 30, 1999. Further, the Comptroller and the Under Secretary of Defense for Acquisition and Technology have committed to (1) improve DOD's physical count procedures to address the weaknesses we identified, (2) implement risk-based physical inventory measures that demonstrate a greater concern for sensitive items and high dollar items, (3) work with DFAS and the audit community to determine the proper treatment of inventory gains and losses, (4) continue refining current formulas for valuing inventory at historical cost, and (5) develop procedures to properly account for and report operating materials and supplies.

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

[15] Defense Inventory: Status of Inventory and Purchases and Their Relationship to Current Needs (GAO/NSIAD-99-60, April 16, 1999).

[16] Valuation and Presentation of Inactive Inventory on the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statements (DOD IG Report 98-195, August 27, 1998).

[17] Defense Inventory: Spare and Repair Parts Inventory Costs Can be Reduced (GAO/NSIAD-97-47, January 17, 1997).

Unreliable Amounts Reported
For General Property, Plant
And Equipment

DOD is responsible for almost one-half of the government's general property, plant and equipment (PP&E).[18] For fiscal year 1998, DOD reported $126 billion of general property assets, including $71.3 billion in real property (land, buildings, facilities, capital leases, and improvements to those assets); $34.7 billion in personal property (such as vehicles, equipment, telecommunications systems, and computers); and $20.3 billion in construction-in-progress, the largest portion of which belongs to the Corps of Engineers. For fiscal year 1998, DOD auditors found that real property databases were generally accurate for recorded items; however, they did identify significant problems with unrecorded items valued at less than $100,000. In addition, DOD's dollar threshold for capitalizing its property, plant, and equipment needs to be reexamined to ensure that the department accurately assesses the full cost of its operations, carries out its fiduciary responsibility over its assets, and prepares accurate and complete financial reports.

Real Property. DOD's real property accounts represented approximately 56% of DOD's reported PP&E for fiscal year 1998. In fiscal year 1998, DOD auditors performed a department-wide effort to test the reliability of each military service's real property logistical databases for existence and completeness. Based upon preliminary results of statistical samples, DOD auditors concluded that assets in the databases with a unit value greater than $100,000 existed at the audit date. However, there were errors identified that may represent systemic problems that will need to be addressed. For example, Naval Audit Service identified 17 sampled items, with a total reported value of $20.1 million, that were inappropriately included in the database. These assets included a building valued at $7 million that was planned but never constructed, a communication antenna valued at $1.9 million that could not be located, and buildings that were demolished but not removed from the database. Army and Air Force auditors also found demolished assets that had not been removed from the databases.

In addition, tests of Air Force assets reportedly valued at less than $100,000 indicated potential accountability issues. For example, based upon the preliminary results of a statistically selected sample of 176 assets with recorded unit values of less than $100,000, Air Force Audit concluded that Air Force's real property database had a 8.62 percent error rate for assets valued at less than $100,000. Furthermore, Navy auditors could not locate 32 of 478 judgmentally selected items with a reported unit value of less than $100,000.

While evaluating the accuracy of assets included in DOD's real property databases, auditors also performed limited tests on whether all assets at DOD installations were included in the databases, i.e., whether the databases were complete. Auditors judgmentally selected assets on the

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

installations and attempted to trace them to the real property databases. For example, at the 62 Army locations reviewed, 48 of 161 items selected were not recorded in Army's real property databases. Most of the unrecorded assets were support facilities and included parking lots, fences, utilities, and storage sheds. In addition, when the Corps of Engineers converted to a new property accounting system this year, it did not transfer to the system approximately $4 billion of assets.

Valuation of real property assets in the databases is perhaps the greatest hurdle the department must overcome. What the department paid for its assets is an important component of determining costs for operating its facilities. For fiscal year 1998, DOD auditors found numerous valuation errors due to duplications, misclassifications, omissions, and lack of supporting documentation. Examples of audit finding of errors in reported values include:

- approximately $9.9 million in capital improvements made at three Army base support battalions which were not recorded,
- approximately 29,000 real property records that were in the Army Corps of Engineers' financial system but had no recorded book value, and
- an estimated $95 million overstatement of real property because the same 48 buildings were included on both Air Force and Navy real property databases.

Ensuring the accuracy of asset valuation can usually be done primarily by verifying acquisitions and disposals during the year but DOD's beginning balances have never been validated. Because DOD acquired many of its assets years ago, adequate documentation is not generally available. Therefore, DOD and the audit community have been working with a contractor to develop an alternative method for supporting its asset values

Personal Property. Because auditors focused on real property testing for fiscal year 1998, only limited work was performed on DOD personal property. However, auditors found that

- Navy improperly excluded from its reported general PP&E approximately $1.5 billion in equipment identified as military trainer devices and inadvertently omitted an additional $739 million in equipment.
- The Air Force Working Capital Fund did not report 155 equipment items costing about $108 million that had been furnished to contractors.
- An Army equipment pricing error had resulted in a $1.2 billion overstatement of personal property because computer monitors valued at $1,345 were in the equipment database at a value of $134.5 million each.

DOD has also hired a contractor to assist it in assessing the existence, completeness, and valuation of assets recorded in its personal property databases. It is expected that this effort may take over a year to complete department-wide, due to the large number of DOD databases used to maintain accountability.

Capitalization Threshold Needs Evaluation. As we testified last year, DOD's ability to accurately report its property, plant, and equipment values has been further hampered by the 20-fold increase in its capitalization threshold from $5,000 in 1991 to $100,000 in 1996, and by the retroactive application of the $100,000 threshold in 1998 to all DOD components, except working capital fund

activities. As a result of the higher capitalization threshold, DOD has expensed billions of dollars of assets, which has effectively removed them from accounting control. These assets have useful lives of more than 2 years. For example, over 100,000 vehicles costing approximately $2.6 billion that are held by the Army, Air Force, and Navy, do not meet the $100,000 capitalization threshold. In addition, financial audits have repeatedly found that DOD's detailed property records are not accurate. For example, based on a statistical sample, Air Force auditors concluded that Air Force's real property database did not provide accountability over assets valued at less than $100,000.

Use of high capitalization thresholds can adversely affect the measurement of operating costs. Because assets are expensed in their year of acquisition, as opposed to the costs of the assets being allocated over their useful lives, the costs associated with their acquisition and use may not be adequately considered in decision-making. In addition, by not accounting for all its costs, DOD's ability to capture the data needed to make valid cost comparisons for decisions, such as outsourcing, is hampered.

The Army Corps of Engineers, which accounts for approximately 26 percent of DOD's total reported PP&E has requested a waiver from implementing the threshold because of its expected impact on the Corps' budget and customers. Corps of Engineers' assets that do not meet the new threshold include "other floating plant equipment" (e.g., barges, boats, launches, and pumps) valued at more than $31 million and "mobile land plant equipment" (e.g., tractors, cranes, and bulldozers) totaling over $48 million.

Short-term Improvements Underway. The DOD Comptroller and the Under Secretary of Defense for Acquisition and Technology are responsible for actions directed at developing more credible valuation data for the department's plant, property, and equipment. To help, the DOD Comptroller has obtained contractor support in addressing both real and personal property issues.

DOD has also directed that its components have or expeditiously develop fully operational property accountability systems that meet federal accounting and systems requirements, including the capability to capture and maintain historical cost data and calculate depreciation for general PP&E assets. Although the DOD Comptroller has designated the Defense Property and Accountability System (DPAS) as DOD's real property accounting system, the Department has encouraged but not mandated that components migrate to DPAS. DPAS databases accounted for approximately $23 billion, or 18 percent of DOD's general PP&E reported for fiscal year 1998. As of March 1999, DOD had approximately 115 DPAS databases operational throughout DOD and an additional 220 scheduled for implementation through May 2000. In our 1997 report on DPAS,[19] we made several recommendations to ensure that financial control and accountability over general property is attained. These recommendations included developing an implementation plan with milestones for DPAS, revising the handbook accompanying the system, and modifying the software to update it for new accounting standards. Actions have been taken to address our recommendations, although DOD has still not developed a detailed DPAS implementation plan.

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[19] Financial Management: DOD's Approach to Financial Control Over Property Needs Structure (GAO/AIMD-97-150, September 30, 1997).

Finally, DOD has recently asked its contractors to evaluate its current capitalization policy. We have offered to work with DOD, its contractors, and the DOD IG to arrive at an approach for reviewing DOD's capitalization policy that will lead to a mutually acceptable conclusion.

Accountability Lacking
Over National Defense Assets

The new Stewardship Reporting accounting standard,[20] which was effective for the first time for fiscal year 1998, required that DOD remove military equipment (now called national defense property, plant, and equipment and reported at more than $600 billion in fiscal year 1997) from its balance sheet and report it on a separate stewardship statement. Although the reporting standards were new, the fiscal year 1998 audit results were similar to last year's because many of the military services' logistics systems used to track and support weapon systems and other military equipment were still unable to provide accurate information to support DOD's asset visibility objectives and financial reporting.

For fiscal year 1997, auditors performed specific tests to validate the data in the logistics systems reporting military equipment. Because of the sensitive nature of the equipment items selected, auditors' audit tests were designed to either "pass" or "fail" the accuracy of logistical system information. For a number of critical systems tested, it was agreed with the military leaders who used those systems that a system would "pass" only where all assets selected from the system were found. For other systems, which generally carry information on less critical assets, it was agreed that the system could still receive a passing grade with up to two errors identified.

Auditors tested recorded information for 11 categories of Navy military equipment. Fiscal year 1997 testing of critical Navy logistics systems showed that the Navy's systems failed for 3 of 11 categories of military equipment tested. Specifically, auditors determined that the Navy's systems relied on for visibility or accountability over active boats, service craft, and uninstalled engines failed because the data were either incomplete or included assets that no longer existed. For example, tests of these mission critical systems found:

- Of 45 boats selected for examination, 2 were included in the Combatant Craft and Boat Support System even though they had been disposed of or sold.
- Of 79 inactive service craft reported in the Naval Vessel Register (NVR) and tested by auditors, 6 could not be located. Fifteen other service craft had been sold or disposed of but were still included in the NVR as inactive, indicating their availability to meet rapid mobilization requirements.
- Of 105 uninstalled engines sampled, 10 valued at up to $4 million could not be found.

Because of the severity of these problems, a working group was established in 1998 to begin addressing them. Navy officials indicated that not adhering to established policies and procedures—for example, those related to the disposal of assets—coupled with disincentives to accurately report asset activity, significantly contributed to these inaccuracies. Officials stated that

[20] The Statement of Federal Financial Accounting Standards No. 8, Supplementary Stewardship Reporting, was effective for federal agencies financial reporting beginning after September 30, 1997.

steps have been taken, including training personnel in existing procedures, and that weapon systems activity is expected to be accurately reported in fiscal year 1999. However, because the problems had not been addressed at the time of their audit, Navy auditors did not repeat tests of national defense assets for fiscal year 1998.

For fiscal year 1997, Air Force logistic systems tested, including those supporting aircraft, missiles and uninstalled engines, passed auditors' tests and auditors made recommendations to correct the minimal number of inaccuracies found during the tests. However, as part of the fiscal year 1998 financial statement audit work, auditors were unable to verify the reported data on 8,387 uninstalled engines, with an estimated value in excess of $8 billion. This occurred because the Comprehensive Engine Management System (CEMS) which is used to report data on these assets, could not separately identify additions and deletions of engines during the fiscal year--a basic control for ensuring accountability over assets.

Audit tests for fiscal year 1997, using the pass-fail approach previously discussed, found that the Army's property books maintained by the local units were generally accurate for major equipment items held by those units. However, the CBS-X, which is intended to provide Army leadership with worldwide visibility over the Army's reportable equipment items, has significant accuracy problems. For example, we have reported[21] that CBS-X was inaccurate because it (1) does not effectively capture data on equipment transactions from all Army units, (2) reflects software errors, and (3) contains transaction posting errors. In addition, like the Air Force's CEMS, CBS-X does not provide accountability and control over Army assets by tracking additions and deletions to asset quantities on hand. Our January 1998 report included over 20 specific recommendations, with which the Army generally concurred, directed towards improving CBS-X accuracy.

Recognizing that CBS-X could not provide effective visibility over equipment maintained by Army units, the Army used a data call to complete its financial reporting for fiscal year 1998 of this equipment and to correct inaccuracies in CBS-X. Army Audit reported that this data call and other procedures identified 1,837 items, which included 10 Army reconnaissance aircraft, 81 Tow missile launchers, and 174 Javelin command-launch units that were not reported to CBS-X. Because these results were based on only 78 percent of the units reporting, as of October 28, 1998, the Army continued to follow up with units that had not reported, and by mid-December, 90 percent of the units had reported. For example, as a result of these additional units reporting, the Army identified another 43 reconnaissance aircraft that were not reported in CBS-X.

Short-term Improvements Underway. The Army and Navy have established working groups to develop plans for addressing problems related to national defense asset accountability. In addition, the Air Force has hired a contractor to assist in implementing accounting standards by developing definitions for differentiating national defense assets from general plant, property, and equipment assets.

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[21] Army Logistics Systems: Opportunities to Improve the Accuracy of the Army's Major Equipment Item System (GAO/AIMD-98-17, January 23, 1998).

REPORTED ENVIRONMENTAL/DISPOSAL LIABILITY SIGNIFICANTLY UNDERSTATED

As we testified last year, DOD has not yet fully implemented the federal accounting standard[22] that requires it to recognize and report liabilities associated with environmental cleanup and/or disposal of its assets. DOD reported $34 billion in estimated liabilities in its fiscal year 1998 financial statements for environmental restoration of active and inactive bases, cleanup of formerly used sites, and cleanup and disposal of certain chemical weapons. However, it did not estimate environmental cleanup and disposal costs associated with military weapon systems (such as aircraft, missiles, ships, and submarines), and ammunition. Further, DOD reported only a small portion of the total cost, estimated to be over $10 billion, for removing unexploded ordnance from its training ranges. As a result, DOD's undisclosed liability in this area is likely understated by tens of billions of dollars. This was a significant factor contributing to our conclusion that the government's environmental and disposal liabilities were understated in its financial statements.[23]

The Congress has also recognized the importance of accumulating and considering such liability information. The National Defense Authorization Act for Fiscal Year 1995 requires the Secretary of Defense to determine, as early in the acquisition process as feasible, the life-cycle environmental costs for major defense acquisition programs, including the materials to be used and methods of disposal. These life-cycle cost estimates are required before proceeding with the major acquisition since reliable information on disposal activity can contribute to the ongoing dialogue on funding comparable weapon systems.

Short-term Improvements Underway. The DOD Comptroller has been working with the Under Secretary of Defense for Acquisition and Technology to develop and issue policy guidance regarding the recognition and reporting of environmental cleanup and asset disposal liabilities. Final guidance has not been issued to DOD components because DOD and the audit community have not reached agreement on when to recognize non-environmental disposal costs. Meanwhile, DOD components have been tasked with developing plans that identify specific actions, with expected completion dates, needed to properly estimate and report liability amounts in accordance with the expected policy guidance.

REPORTED LIABILITY FOR POST-RETIREMENT HEALTH CARE UNSUPPORTED

Last year, we reported that DOD did not accumulate the data necessary to accurately estimate its military post-retirement health benefits liability, and this remained a problem for fiscal year 1998.

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[22] Statement of Federal Financial Accounting Standards No. 5, Accounting for Liabilities of the Federal Government.

[23] Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997), Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997), Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19,1997), Financial Management: DOD's Liability for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).

Instead of the required cost data, DOD used budget obligations to calculate its $223 billion estimated liability. However, budget obligations may not capture the full costs of treatment facilities or some personnel costs, such as pension benefits. In addition, the costs represented by budget obligations differed significantly from the costs in DOD's official medical cost accounting system, the Medical Expense and Performance Reporting System, and the two were not reconcilable. DOD needs reliable cost data to estimate its future retiree health care liability but, more importantly, to properly allocate its resources, decide whether to provide services internally or through an outside party, set third-party billing rates, and benchmark its health delivery system with those of other providers.

DOD also did not accumulate current or complete historical claims data, which is necessary to determine the type of health care services provided, to support its fiscal year 1998 calculation; instead, 1994 claims and service data were used. For outpatient services, which are estimated to comprise over 40 percent of the dollar value of all claims and services, data were available from only 15 of 121 Military Treatment Facilities. Finally, while DOD relies on data from its Composite Health Care System (CHCS) to determine the number of retiree outpatient visits to Military Treatment Facilities, and therefore retiree outpatient costs, auditors found that CHCS data is often not supported by documentation in medical records. In addition, auditors found that visits were double counted and that invalid telephone conversations were counted as visits.

Short-term Improvements Underway. DOD has made progress in addressing the issues noted in prior years and has additional improvement efforts underway or planned to support its reporting in this area. DOD has (1) established a working group to identify changes needed in its medical cost accounting system, (2) gathered outpatient data from all of its Military Treatment Facilities that are now operating, (3) obtained claims data as recent as fiscal year 1997 to be used in the calculation, and (4) established a working group to develop standardized management controls for the Military Health System's automation systems. DOD also reports that detailed information on the nature of outpatient visits, including the actual medical procedures performed, may be available through a recently implemented DOD outpatient data system to support its reporting for this area beginning with fiscal year 1999. Auditors have been and will continue working with DOD to improve its cost accounting for health care.

COST OF DOD OPERATIONS NOT ACCURATE

Our audit of the U.S. government's consolidated financial statements found that the government was unable to support significant portions of the more than $1.8 trillion reported as the total net cost of government operations. DOD accounts for about $280 billion of that amount but its financial management systems do not capture the full cost of its activities and programs. The accuracy of Department's reported operating costs was affected by DOD's inability to properly value and capitalize its facilities and equipment, properly account for and value its inventory, identify its environmental and disposal costs, determine its costs associated with post-retirement health care for military personnel, and reconcile its records with those of Treasury and other agencies. In addition, DOD does not have the basic, transaction driven, double-entry accounting systems that are necessary to properly control assets and accumulate costs.

To effectively, efficiently, and economically manage DOD's programs, its managers need reliable cost information for (1) evaluating programs, for example, measuring actual results of management's actions against expected savings or determining the effect of long-term liabilities created by current programs, (2) making economic choices, such as whether to outsource specific activities and how to improve efficiency through technology choices, (3) controlling costs for its weapon systems and business activities funded through working capital funds, and (4) measuring performance. As we recently testified, the lack of reliable, cost-based information hampers DOD in each of these areas.[24] For example,

- 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 weapon systems.
- DOD is unable to provide actual data on the costs associated with functions to be considered for A-76 outsourcing competitions, including the capital costs associated with its operations.
- DOD has long-standing problems accumulating and reporting the full costs associated with working capital fund operations, which provide goods and services in support of the military services. As a result, there have been large fluctuations in working capital fund surcharges and, therefore, in the prices charged to customers.
- As part of its Results Act Performance plan for fiscal year 2000, DOD has developed 43 unclassified performance measures and indicators to measure a wide range of activities—from force levels to asset visibility, but these measures and indicators contain few efficiency measures based on cost.[25]

Short-term Improvements Underway. As discussed in earlier sections, DOD has begun addressing problems with assets and liabilities that affect the reliability of its reported net costs. However, developing the needed basic, double-entry accounting systems and cost accounting systems is a long-term effort towards which DOD has taken only the first steps.

RELIABILITY OF BUDGET DATA IMPAIRED

For fiscal year 1998 reporting, federal accounting standards required agencies to prepare a new Statement of Budgetary Resources that would reconcile their reported net costs to budget information. As part of the DOD fiscal year 1998 financial statement audit, auditors found several areas in which the systems and controls over DOD's use of its budgetary resources were ineffective: (1) DOD does not know the true amount of funds that are available to obligate and spend in its appropriation accounts because obligated balances are not always correct or supported, (2) reconciliations between DOD and Treasury records are not being adequately performed, (3) interagency transactions are not being identified and reconciled, and (4) certain disbursements are not being recorded promptly in DOD's accounting records. As a result, the Congress cannot be assured that DOD did not overexpend its budget authority for individual appropriation accounts or spend more for specific programs for which the Congress established spending limits. Conversely, these fund control weaknesses also result in the department's inability to properly identify and

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

[25] Results Act: DOD's Annual Performance Plan for Fiscal Year 1999 (GAO/NSIAD-98-188R, June 5, 1998).

manage remaining budget authority, so that funds the Congress intended for specific DOD programs may be unused and eventually cancelled.

Some Recorded Obligations Are Incorrect. Auditors found that recorded obligations included amounts that were no longer correct or were unsupported. Specifically, at the Air Force, the only DOD component performing a full financial audit of its obligated balances, an estimated $4.3 billion of a $34 billion balance in obligations was found to be incorrect or unsupported. For example, obligated balances may not have been adjusted when goods or services were delivered at a lesser cost or when contracts were modified. In limited tests, the Naval Audit Service found that $101 million of $592 million of unliquidated Navy contract obligations, or approximately 17 percent, were incorrect. Army auditors also found evidence of unsupported obligations but were unable to quantify the extent of the problem.

Reconciliations Not Adequately Performed. Comparable to an individual reconciling his or her checkbook to a bank statement, DOD's records on its available funds should be reconciled to Treasury records. An effective reconciliation of DOD's and Treasury's records requires not only identifying differences but also determining the appropriate adjustments to resolve the differences. As important as these reconciliations are to all federal agencies, they are critical for DOD. This is because authorized transactions are often charged to DOD's appropriation accounts by entities not directly responsible for the appropriations; for example, the Army may write a check to pay a Navy vendor and cite a Navy appropriation account.

As of September 30, 1998, a comparison of DOD's and Treasury's records showed the absolute value of unresolved differences amounted to $9.6 billion, of which $7.4 billion related to checks disbursed and the remainder to deposits, electronic funds transfers, and interagency transactions. These unresolved differences could significantly affect the status of budget authority available to be obligated and expended. Differences between DOD and Treasury records can result from one or more of the following: (1) DOD delays in reporting transactions to Treasury, (2) Treasury delays in posting transactions to DOD accounts, and (3) errors or fraud.

Reconciliations are a key control for detecting errors or fraud. For example, in 1991, an Army disbursing station made a deposit for nearly $2.1 million, but the bank mistakenly recorded the deposit for only $3,458.89—the deposit ticket number. Because Army failed to reconcile its records with Treasury's records, this error went undetected until auditors found it during 1998. The bank subsequently repaid the government the correct deposit amount plus $640,000 in interest.

DOD's records also show an estimated $823 million held in suspense accounts at the end of fiscal year 1998 that have not been properly reported to Treasury and are not reflected in the differences between Treasury and DOD records noted above. Until these transactions are posted to the proper appropriation account, the department will have little assurance that the collections and adjustments recorded in these accounts are authorized transactions and that its disbursements do not exceed appropriated amounts. Moreover, the reported $823 million represents the offsetting (netting) of collections and adjustments against disbursements, thus understating the magnitude of the unreported amounts. For example, 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 for fiscal year 1997, the individual transactions, collections as well as disbursements, totaled about $5.9 billion.

Inter- and Intra-agency Transactions Not Properly Reconciled. In order to portray DOD as a single entity and the federal government as a single economic unit, certain transactions that occur between DOD and its components and DOD and other federal agencies must be identified and eliminated. If interagency transactions are not properly reconciled and eliminated, both the costs and revenues of DOD and the government are overstated. In addition, agency payables and receivables, when not reconciled, can lead to agencies exceeding their total budget resources. For example, a DOD receivable from another federal agency represents an increase in net budget authority to DOD. If the agency that owes DOD does not record a corresponding payable or obligation and the amounts are not reconciled, then both agencies have overstated their activity.

To make the fiscal year 1998 consolidated governmentwide financial statements balance, Treasury had to record a net $24 billion item on the Statement of Changes in Net Position, which it labeled unreconciled transactions. This out-of-balance amount was the net of more than $250 billion of unreconciled transactions--both positive and negative amounts—which Treasury attributed largely to the government's inability to properly identify and eliminate transactions between federal government entities. DOD's inability to identify and eliminate activity and balances resulting from transactions among DOD entities and DOD and other federal agencies significantly contributed to this problem.

Recently, the Comptroller requested from all DOD components, information on transactions between organizational entities and between the department and other federal agencies. The Comptroller has stated his intention to use the gathered information to develop departmentwide guidance and procedures for reporting elimination entries for the fiscal year 1999 financial statements. However, DOD components have indicated that it is unlikely that reliable information will be forthcoming for both the buyer and the seller side of DOD transactions to permit intra-DOD and interagency transactions to be properly eliminated next year.

Disbursements Not Properly Recorded. The auditors' concerns raised about the reliability of the department's budget information are further exacerbated by the department's problem disbursements--disbursements that are not properly matched to specific obligations recorded in the department's records. DOD's continuing problems with its complex and inefficient payment processes generally result in transactions not being recorded until long after they have occurred. This is because DOD's payment and accounting processes are generally separate functions carried out by separate offices in different locations without integrated systems. As a result, accounting for a payment does not occur until after a disbursing station has issued a payment and has forwarded the payment information to the accounting station. Problems in transaction processing arise when the accounting stations are not provided the information or documentation that permits them to properly record transactions.

DOD reported problem disbursements at $17.3 billion as of September 30, 1998. To the extent that these disbursements cannot be matched to existing recorded obligations, DOD would be required to record a new obligation, which could create an Antideficiency Act[26] violation if the available

[26] 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 the payment of money "before an appropriation is made." (31 U.S.C. 1341 (a))

unobligated balances in the department's applicable appropriation accounts were insufficient to cover the amount of the obligation.

Overspending/Cancellation of Funds Can Occur. Recent audit reports have described the consequences of the department's inability to keep track of its obligations and expenditures. Specifically, auditors found several instances in which the department may have spent more than authorized amounts. For example, the Air Force Audit Agency reported that Air Force's Depot Maintenance Activity--a component of one of the department's working capital funds--may have incurred obligations of $1.1 billion in excess of available budgetary resources as of September 30, 1998. In addition, as we previously reported,[27] according to Navy records, as of September 30, 1997, obligations in 29 canceled and expired appropriations may have exceeded available budget authority by a total of $290 million.

DOD's inability to properly identify and manage its remaining budget authority can result in funds that the Congress intended for specific DOD programs, being unused and eventually cancelled. For example, at the end of fiscal year 1998, the department had $4.3 billion in expired budget authority that cancelled.

Short-term Improvements Underway. DOD has not yet developed a short-term action plan to address problems with incorrect and unsupported obligation data that were identified as a result of auditing this information for the first time as part of the fiscal year 1998 financial statement audit. However, DOD has acknowledged that these issues cannot be resolved without the underlying process and systems improvements identified in its long-term financial management improvement strategy.

DOD has a number of initiatives to address problem disbursements, including (1) implementation of a single cash accountability system that will be used to report disbursements to the U.S. Treasury and (2) prevalidation. The prevalidation initiative requires that obligations be matched to disbursements before the payment is made.

In addition, DOD has been taking actions to improve its processes for reconciling its records with those of Treasury. The Defense Finance and Accounting Service has drafted standardized procedures for its centers to follow in reconciling DOD and Treasury accounts monthly, including researching and resolving any differences. DFAS centers are also required to begin reconciling balances in budget clearing accounts and suspense accounts with the transaction-level detail maintained for each military service.

EXTENT OF IMPROPER PAYMENTS NOT FULLY DETERMINABLE

While our work continues to identify numerous examples of improper and unsupported DOD payments, such as the problem disbursement issues previously discussed, the true magnitude of DOD's payment problems is unknown. Significant weaknesses have been identified in contractor and vendor payments as well as health care provider payments.

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[27] Financial Management: Problems in Accounting for Navy Transactions Impair Fund Control and Financial Reporting (GAO/AIMD-99-19, January 19, 1999).

Improper Contract and Vendor Payments. We have long reported on DOD's problems in making accurate payments to defense contractors.[28] Our work continues to identify problems with overpayments and erroneous payments to contractors. For example, in the 5 years between fiscal years 1994 and 1998, defense contractors returned about $4.6 billion to the DFAS Columbus Center, including $746 million in fiscal year 1998, due to overpayments caused by contract administration actions and payment processing errors.

In compiling Navy's fiscal year 1998 financial statements, DFAS identified a negative (debit) accounts payable balance of $3.6 billion. Typically, such negative accounts payable balances would represent duplicate or overpayments to vendors or contractors; however, DFAS did not conduct an investigation to determine the cause of this negative balance. Instead, DFAS and Navy made unsupported adjustments of more than $6 billion to bring the Accounts Payable balance to the reported credit balance of $2.4 billion.

In addition to the amounts voluntarily returned by defense contractors, the Defense Contract Audit Agency (DCAA) also identifies funds for recovery from major defense contractors. Defense contractors submit bills for goods and services to DOD for payment. Prior to the submission of these bills, the contractor certifies that the bills are proper and payment is warranted. DOD pays these bills pending an audit by DCAA. DCAA contract audits determine whether the billed amounts comply with prescribed overhead rates, contract ceilings, or certain Federal Acquisition Regulations. If DCAA determines that the amount billed and paid was not warranted, DCAA disallows the costs and DOD recovers the funds. For fiscal years 1994 through 1998, the Defense Contract Audit Agency disallowed $6.8 billion—$1 billion or more per year—in certified bills from defense contractors.

DOD also has problems with improper and fraudulent vendor payments—payments for goods and support services.

- An August 1998 Naval Audit Service report[29] identified $6.2 million in duplicate and erroneous Navy vendor payments out of $369.2 million tested. Naval Audit concluded that these improper payments were caused by a lack of written policies and procedures for certifying and processing vendor invoices, certifying officer errors, accounting technician data input errors, and payment by two different paying activities for the same goods and/or services.
- In September 1998, we reported[30] on internal control and systems weaknesses that contributed to two cases of Air Force vendor payment fraud—one resulting in the embezzlement of over $500,000 and the other resulting in embezzlement of $435,000 and attempted theft of over $500,000. We found that the lack of segregation of duties and other control weaknesses, such

[28] DOD Procurement: Funds Returned by Defense Contractors (GAO/NSIAD-98-46R, October 28, 1997) and DOD Procurement: Millions in Overpayments Returned by DOD Contractors (GAO/NSIAD-94-106, March 14, 1994).

[29] Duplicate and Erroneous Payments (Naval Audit Service Report No. 041-98, August 7, 1998).

[30] Financial Management: Improvements Needed in Air Force Vendor Payment Systems and Controls (GAO/AIMD-98-274 and related testimony GAO/T-AIMD-98-308, September 28, 1998).

as weak controls over remittance addresses, created an environment where employees were given broad authority and the capability, without compensating controls, to perform functions that should have been performed by separate individuals under proper supervision. We also found that over 1,800 DFAS and Air Force employees had a level of access to the vendor payment system that allowed them to submit all the information necessary to create fraudulent and improper payments.

Health Care Fraud. In February 1999, the DOD IG reported[31] that the Defense Criminal Investigative Service (DCIS) had about 500 open criminal investigations on health care fraud. DCIS efforts over the last 5 fiscal years have resulted in 343 convictions and $1 billion in recoveries. Generally, the health care fraud cases investigated by DCIS cover defective and fraudulent claims--the same issues as Medicare fraud. Under DOD's fee-for-services health care programs, most provider fraud was accomplished through ordering and billing for unnecessary care, laboratory tests, durable medical equipment, or x-rays. For example, a pharmaceutical company submitted greatly inflated insurance billings through the unbundling of clinical test profiles, fabricating test codes, and double billing for tests not performed. The company agreed to pay $325 million to resolve issues of civil false claims to Medicare and military and other federal and state health care programs.

Short-term Improvements Underway. Due to the seriousness of DOD vendor and contractor payment systems and control weaknesses, DOD has initiated corrective actions to strengthen system and internal controls over its payment operations. In the area of contractor overpayments, DOD has developed procedures intended to help identify and collect such amounts in a timely manner. Other actions include revising internal control guidance to better assure separation of duties for all its financial operations and limiting access to payment and accounting systems. To address health care fraud, DCIS is participating in national Department of Justice-sponsored working groups to identify emerging trends in health care fraud and coordinate activities of members conducting investigations involving new schemes in managed care fraud.

CRITICAL AREAS TO BE ADDRESSED TO MEET FINANCIAL REFORM GOALS

On May 26, 1998, the President directed the head of each agency designated by OMB to identify corrective actions to resolve financial reporting deficiencies and to make quarterly progress reports to OMB. The administration's goal is to have individual agencies, as well as the government as a whole, complete audits and gain unqualified opinions on their financial statements. In response, the DOD Comptroller has been developing and implementing short-term steps in collaboration with DOD's functional and audit communities, OMB, and the GAO, as discussed in the previous sections.

However, an unqualified audit opinion, while certainly important, is not an end in itself. Efforts to obtain reliable year-end data that are not backed up by fundamental improvements in DOD's underlying financial management systems and operations to support ongoing program management

[31] Statement of DOD Inspector General on Department of Defense Vulnerabilities to Waste, Fraud and Abuse Before the Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform (February 25, 1999).

and accountability, will not achieve the intended results of the Chief Financial Officers Act—fundamentally reforming financial operations to enable the production of reliable financial management information supporting day-to-day decision-making. In this context, it is essential that DOD also establish a well-trained cadre of financial management personnel, a short-term improvement action that will help address the financial management weaknesses previously identified as well as help ensure that the improvement actions cited are implemented as efficiently and effectively as possible. Longer term actions addressed in DOD's first Biennial Plan also will be essential for the Department to prepare reliable financial statements as well as to make planned major financial management system improvements throughout DOD's large and complex organization.

Enhanced Training for Financial Management Personnel

One of the key issues facing DOD is the need to ensure that its financial management personnel have the knowledge and skills required to reliably carryout basic transaction processing just discussed throughout DOD's large and complex organization. Our work[32] has shown that state governments and private sector organizations place a strong emphasis on training as a means of upgrading financial workforce knowledge of accounting and financial management requirements. In contrast, the results of a survey we conducted of key DOD financial managers showed that over half of those surveyed had received no financial- or accounting-related training during 1995 and 1996.[33]

DOD leadership has acknowledged that it needs to improve the capabilities of its financial managers, and DFAS is developing a program intended to identify the kinds of skills and developmental activities needed to improve the competencies of its financial personnel. We have recommended that DOD modify its planned program to better ensure that financial management personnel throughout the department receive necessary training, including establishing minimum training requirements emphasizing technical accounting and related financial management courses. This recommended approach is similar in scope to the program recently put in place to improve the skills of the department's acquisition workforce.

Updates to Long-term Improvement Plan
Need to Incorporate Additional Elements

The National Defense Authorization Act for Fiscal Year 1998 (Public Law 105-85) required the Secretary of Defense to biennially submit to the Congress a strategic plan for the improvement of financial management within DOD. The plans are to address all aspects of financial management within DOD, including the finance systems, accounting systems, and data feeder systems that support its financial functions, including the Department's concept of operations for financial management.

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[32] Financial Management: Profile of Financial Personnel in Large Private Sector Corporations and State Governments (GAO/AIMD-98-34, January 2, 1988).

[33] Financial Management: Training of DOD Financial Managers Could Be Enhanced (GAO/AIMD-98-126, June 24, 1998).

DOD submitted its first Biennial Plan to the Congress on October 26, 1998. The Department has committed to update the plan annually rather than biennially as required by law. This first plan presents DOD's concept of operations, the current environment, and the transition plan intended to describe the goals of the Department for achieving the target financial management environment and to identify the strategies and corrective actions necessary to move through the transition. It also provides information on the specific financial management improvement initiatives intended to implement the transition plan.

We have analyzed DOD's first plan and, in January 1999, reported[34] the results of our analysis to the Senate and House Armed Services Committees. As we stated in our report, DOD's plan represents a great deal of effort and provides a first-ever vision of the department's future financial management environment. In developing this overall concept of its envisioned financial management environment, DOD has taken an important first step in improving its financial management operations. The department's plan also represents a significant landmark because it includes, for the first time, a discussion of the importance of the programmatic functions of personnel, acquisition, property management, and inventory management to the department's ability to support consistent, accurate information flows to all information users. In addition, DOD's plan includes an extensive array of initiatives intended to move the department from its current state to its envisioned financial management environment.

If effectively implemented, the initiatives discussed should result in improving DOD's financial management operations. However, we also reported that modifications to the plan are needed if DOD is to achieve the full range of reforms needed. Specifically, the Department's planned update should include:

- A revised concept of operations. A revised concept of operations needs to reflect, at a high level, the full range of the department's financial management operations, including (1) how it will support budget formulation and (2) how its financial management operations will effectively support not only financial reporting, but also asset accountability and control. In particular, including the role of department's Programming, and Budgeting System (PPBS) in its concept of operations will be essential to the development of a fully integrated financial management system. Such an integrated system will help ensure that budgets consider financial implications and that policy decisions are based on sound financial information.

- Shared servicing and outsourcing strategies. Many leading organizations have used shared servicing strategies built on a three staged process focused on (1) consolidation, (2) standardization, and (3) re-engineering financial operations to reduce the cost of, and improve the control over, day-to-day accounting operations. With respect to outsourcing, our October 1997 report[35] on the results of our survey of selected private sector and nonfederal public organizations use of outsourcing showed that (1) developing a structured approach for identifying functional areas to be considered for outsourcing, (2) identifying the criteria to be

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

[35] Financial Management: Outsourcing of Finance and Accounting Functions (GAO/AIMD/NSIAD-98-43, October 17, 1997).

used in determining whether or not to outsource a specific function, and (3) establishing effective controls to oversee outsourcing vendors, were fundamental to achieving projected cost savings, process cycle time reductions, and other expected financial management improvements.

- Clarification of Transition Plan. The transition plan needs to clarify the role that the 200 planned improvement initiatives will play in bridging the gap between the current environment and the envisioned future concept of operations and the steps the department will take to ensure that it will build reliability into the data provided by its feeder systems.

- Concepts of Clinger-Cohen. The plan should include the concepts established in the Clinger-Cohen Act (40 U.S.C. 1401) for effectively implementing the technology improvement initiatives contained in the plan, including establishing processes to help ensure that such initiatives are implemented at acceptable costs, within reasonable and expected time frames, and are contributing to tangible, observable improvements in mission performance.

While these problems must be addressed over the long term, we recognize that in the short term, the department still must focus on the Year 2000 computing challenge.[36] However, DOD now has a unique opportunity to capitalize on the valuable lessons it has learned in addressing the Year 2000 issue and apply them to its overall management of financial management and information technology. Doing so can enable the department to acquire high performing, cost-effective systems and to avoid repeating costly mistakes. For example,

- Without the continuing, active involvement of top-level managers, major management reform efforts cannot succeed.
- Maintaining a reliable, up-to-date system inventory is fundamental to well-managed financial management and information technology programs.
- DOD has spent 3 years identifying system interfaces and implementing controls at the system level that should help prevent future data exchange problems in its systems and resolve conflicts between interface partners.
- Once the Year 2000 effort is completed, DOD can use the operational and functional evaluations to further identify and retire duplicative and unproductive systems.

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The Secretary of Defense has expressed the Department's commitment to financial management reform. He recently announced that he was expanding his Defense Reform Initiative to include financial management. Achieving effective reform will entail the involvement and dedication of top management. Working through the Defense Management Council or a similar structure of the Department's high-ranking leadership, such as that used to address the Year 2000 computing crisis, is a key factor in achieving major change within the organization.

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[36] Year 2000 Computing Crisis: Defense Has Made Progress, But Additional Management Controls Are Needed (GAO/T-AIMD-99-101, March 2, 1999).

In closing, Mr. Chairman, sustained congressional attention to governmentwide financial management reform, such as that provided by this hearing, will be critical to instilling expected accountability in DOD and other agencies across government.

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

RELATED GAO PRODUCTS

PROPERTY, PLANT, AND EQUIPMENT

Financial Management: Accounting Implications of DOD's Facilities Demolition Programs (GAO/AIMD-98-194R, August 28, 1998).

Financial Audit: DOD Mission Asset Existence Verification (GAO/AIMD-98-196R, May 29, 1998).

Army Logistics Systems: Opportunities to Improve the Accuracy of the Army's Major Equipment Item System (GAO/AIMD-98-17, January 23,1998).

Financial Management: DOD's Approach to Financial Control Over Property Needs Structure (GAO/AIMD-97-150, September 30, 1997).

Financial Management: Air Force Budget Request Could Be Enhanced with More Complete Aircraft Data (GAO/AIMD-97-137R, August 21, 1997).

Financial Management: Accuracy of Air Force Aircraft and Missile Data Could Be Improved (GAO/AIMD-97-141R, August 15, 1997).

CFO Act Financial Audits: Navy Plant Property Accounting and Reporting Is Unreliable (GAO/AIMD-96-65, July 8, 1996).

INVENTORY

Defense Inventory: Status of Inventory and Purchases and Their Relationship to Current Needs (GAO/NSIAD-99-60, April 16, 1999).

Defense Inventory: DOD Could Improve Total Asset Visibility Initiative With Results Act Framework (GAO/NSIAD-99-40, April 12, 1999).

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

Defense Inventory: Continuing Challenges in Managing Inventories and Avoiding Adverse Operational Effects (GAO/NSIAD-99-83, February 25, 1999).

Department of Defense In-Transit Inventory (GAO/NSIAD-98-80R, February 27, 1998).

Financial Reporting: DOD's Fiscal Year 1996 Financial Statements Inventory Reporting Does Not Meet Standards (GAO/AIMD-98-16, December 24, 1997).
Defense Inventory: Inadequate Controls Over Air Force Suspended Stocks (GAO/NSIAD-98-29, December 22, 1997).

Defense Logistics: Much of the Inventory Exceeds Current Needs (GAO/NSIAD-97-71, February 28, 1997).

Defense Inventory: Spare and Repair Parts Inventory Costs Can Be Reduced (GAO/NSIAD-97-47, January 17, 1997).

Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings (GAO/AIMD-96-94, August 16, 1996).

Defense Ammunition: Significant Problems Left Unattended Will Get Worse (GAO/NSIAD-96-129, June 21, 1996).

ENVIRONMENTAL/DISPOSAL LIABILITY

Financial Management: DOD's Liability for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).

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

Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997).

Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997).

DISBURSEMENTS

Financial Management: Problems in Accounting for Navy Transactions Impair Funds Control and Financial Reporting (GAO/AIMD-99-19, January 19, 1999).

Internal Controls: Reporting Air Force Vendor Payment System Weaknesses Under the Federal Managers' Financial Integrity Act (GAO/AIMD-99-33R, December 21, 1998).

Financial Management: Improvements Needed in Air Force Vendor Payment Systems and Controls (GAO/AIMD-98-274, September 28, 1998 and GAO/T-AIMD-98-308, September 28, 1998).

Financial Management: Seven DOD Initiatives That Affect the Contract Payment Process (GAO/AIMD-98-40, January 30, 1998).

DOD Procurement: Funds Returned by Defense Contractors (GAO/NSIAD-98-46R, October 28, 1997)

Financial Management: DOD Progress Payment Distribution Procedures (GAO/AIMD-97-107R, June 21, 1997).

Financial Management: The Prompt Payment Act and DOD Problem Disbursements (GAO/AIMD-97-71, May 23, 1997).

Financial Management: Improved Reporting Needed for DOD Problem Disbursements (GAO/AIMD-97-59, May 1, 1997).

DOD Problem Disbursements Contract Modifications Not Properly Recorded in Payment System (GAO/AIMD-97-69R, April 3, 1997).

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(918964)

Mr. HORN. Well, we thank you and the GAO for that very thorough statement.

Our last witness this morning is the Honorable William Lynn, the Under Secretary of Defense, Chief Financial Officer of the Department of Defense. And he's accompanied by Mr. Nelson Toye, the Deputy Chief Financial Officer, Department of Defense.

Mr. Lynn.

Mr. LYNN. Thank you very much, Mr. Chairman. I was going to thank you for the opportunity to be here, but since you've sworn me in, I thought better of that.

Mr. HORN. Right.

Mr. LYNN. I do appreciate you putting the full statement in the record, and I will just try and summarize it in the 10 minutes that you've allotted. Let me start, you know——

Mr. HORN. You can take more time if you want.

Mr. LYNN. Let me start by stressing what both Mr. Mancuso, Mr. Dodaro said is that the effort in financial management reform is important. It is a priority at the highest levels of the Department, starting with Secretary Cohen and Deputy Secretary Hamre and, I, as the Chief Financial Officer and the implementer of their will on this.

And I want to talk about the progress we've made so far and what our plans are for further progress over the next several years.

In terms of where we are right now, what progress we've made so far, the way I would describe it, we've laid the foundations for a massive shift of the DOD financial management systems from a 200-year focus on an obligation-based system toward a more commercial style accrual-base system.

This is not an easy shift, particularly, with an operation the size of the Department dwarfs any private sector enterprise that dwarfs any other government enterprise. But we need—despite the challenge, we need to be able to do this for exactly the reasons Mr. Dodaro cited in his testimony, which I would summarize as cost visibility and public confidence, in terms of the accounting systems and the finance systems where a good portion of the Nation's tax dollars are spent.

The foundations that we've laid here are three. First was the creation of DFAS by the prior administration in 1991. The Defense Finance and Accounting Service is the critical, pivotal agent for financial management reform. The creation of DFAS has allowed to consolidate financial operations, eliminate non-Chief Financial Officer compliant finance and accounting systems, and fundamentally reengineer our business practices to accomplish these goals.

The second major foundation is that of consolidation. Since 1991, we've consolidated from 330 Defense accounting offices down to 5 centers and 20 operating locations. This is a reduction of over 90 percent. It's been accomplished in 7 years. That's 2 years earlier than planned. It saved us money; but probably, more importantly, it's eliminated redundancy and facilitated the standardization and improved the accuracy and time limits of all of our financial operations.

And that's, in fact, the third element of the foundation of these financial reforms is that consolidation. To remedy the problem we had of too numerous and incompatible finance and accounting sys-

tems, DFAS embarked on a major streamlining effort. We started in 1991 with 324 finance and accounting systems. We are on a path to reduce that by 90 percent, down to 32 by 2003. We're just over 100 right now.

The number of 100 compares favorably with most fortune—or the top Fortune 500 companies. The number of 32 will put us in the upper tier of those companies. And we are right now on track to do that. But the objective is not simply to reduce the number of finance systems. The consolidation effort, rather, is meant to eliminate outdated financial management systems and replace them with systems that provide more accurate, more timely, and more meaningful data to decisionmakers.

It's that data that gives you the cost visibility that gives the taxpayers the confidence that we are, indeed, good stewards of the national defense resources. With those foundations which, as I say, we just completed the consolidation effort, in the last year and we're about two-thirds of the way through the effort to streamline our finance and accounting services, we've been able in the last year to turn to next steps. And those next steps have been alluded to by the previous two witnesses.

They focus now on an area that we have not focused as heavily on because we were not able to, but we can now focus on the achievement of clean opinion on an auditable financial statement. With the foundations laid by DFAS's consolidation of the accounting stations and the financial management systems, we are able to take the next steps of focusing on a clean audit opinion.

We've been working closely on the last year with our partners at GAO and the Inspector General, who are here, as well as the Office of Management and Budget, to develop both a short-term and a long-term strategy. Why do we need two strategies? The fundamental fact is the long-term strategy, as Mr. Mancuso indicated, requires a complete overhaul of the Department's management information systems. Now, that goes far behind the improvements in the finance and accounting systems that I described just a moment ago.

As was indicated earlier, more than 80 percent of the data that is on a finance—on our financial statement comes from outside the financial systems. It comes from the logistics systems. It comes from the personnel systems, from the acquisition systems, from the medical systems. So in order to achieve a clean financial opinion, we need to integrate those systems into our reporting chain.

That requires upgrades of those systems so that they're CFO compliant and it requires improved interfaces with the financial systems. The financial management improvement plan that we submitted this past fall is the first step in that effort. We need to improve on that plan, but we think that lays a cornerstone in our effort to get a clean opinion.

While there's no substitute, as Mr. Mancuso indicated, for the system changes, in terms of achieving the long-term goals, those goals will take several years, maybe more than several years. Accordingly, we've developed a short-term strategy to try and accelerate the achievement of a clean opinion on our financial statements.

We've been working with the GAO and the Inspector General and OMB to develop this strategy. They've been very helpful in

identifying the major deficiencies in our financial management reporting. And we've focused a series of interim methodologies on each of those deficiencies to try and narrow the deficiency down, such that we would at least be able to achieve a clean financial opinion in advance of getting all the systems improvements that are in the pipeline now.

Let me just give you one or two examples of what we're doing. Probably the best example is in the area of real property, real property—and personal property as well. The problem we have there is the Department only keeps paperwork for 6 years and 6 months, most 6 our—almost all of our real property and much of our personal property has been around much longer than that.

The paperwork for those properties, however, is no longer around. That's a problem for the auditors. We don't have an audit train that goes back to the acquisition of that property and goes through to the current time. I think all of us agree that the auditors, as well as DOD, agree that it would not be worth the effort to try and find the receipt for, say, West Point. It's not a helpful project. On the other hand, it is a useful step to know what the value of that property is.

And so what we've undertaken with two CPA firms is for them to develop a methodology for us to value our current inventory of both real property and personal property and then to set up a system that will continually update those valuations so that they will be usable for audit purposes. That's an example of the kinds of interim methodology that addresses one of the principal deficiencies that cause the Department not to be able to achieve a clean opinion on its financial statements.

Let me just conclude by saying the Department takes full responsibility for its financial stewardship. We take that responsibility seriously. As I say, it goes straight to the top, to the Secretary. We're taking substantial steps in the direction of reform. As I mentioned, we've already taken the steps to lay the foundation with DFAS and the consolidation of the accounting stations, as well as the finance and accounting systems.

We are now expanding that effort to include all of the feeder systems that involve the 80 percent of the data outside the financial systems. And we're working with GAO, the IG, and the OMB to develop an interim approach to try and achieve an even more accelerated goal of clean financial opinion.

But I think we always need to remember that as we go through this effort, that this is an effort that the Department cannot stop to achieve. Every month we have to pay our 2 million members of the military, both active and reserve, our 700,000 civilians. We have to pay $24 billion a month in contractor and vendor payments. None of that can stop.

So financial management for the reform for the Department of Defense is a lot like changing the wheels on an automobile without stopping. We've changed one or two of those wheels; we are not all the way there. We will not stop, though, until we achieve our overall goals. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Lynn follows:]

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Reform Committee

STATEMENT OF THE HONORABLE WILLIAM J. LYNN

UNDER SECRETARY OF DEFENSE (COMPTROLLER)
CHIEF FINANCIAL OFFICER

DEPARTMENT OF DEFENSE

BEFORE THE

COMMITTEE ON GOVERNMENT REFORM

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION,
AND TECHNOLOGY

ON

FINANCIAL MANAGEMENT WITHIN THE DEPARTMENT OF DEFENSE

May 4, 1999

For Official Use Only
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House Government
Reform Committee

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

Mr. Chairman and Members of the Subcommittee, I am pleased to be here today to discuss financial management within the Department of Defense. Let me say at the outset that Secretary Cohen is committed to financial management reform within the Department of Defense. Moreover, as the Chief Financial Officer for the Department of Defense, this is one of my top priorities. Reflecting the resolve of the Department's senior leadership, we have undertaken the most comprehensive reform of financial management systems and practices in the Department's history.

I am here today for two important reasons. First, I want to assure this Subcommittee and the American people that the Department of Defense is a good steward of the resources entrusted to it. Second, I want the Congress and the American people to be aware of the comprehensive financial management reforms underway within the Department. Thus, I appreciate this opportunity to highlight for this Subcommittee the major initiatives underway to promote improved financial management throughout the Department while maintaining our forces at the highest level of readiness and effectiveness.

SOUND FINANCIAL MANAGEMENT MATTERS

Sound financial management is important within the Department of Defense for three main reasons:

First, sound financial management practices provide cost visibility. Knowing how much we are paying for what we are buying provides decision-makers, both field commanders and senior managers, with timely and accurate cost information needed to sustain maximum effectiveness. Additionally, accurate cost information is important to the Department's ability to apply funds more precisely to modernization, training, and investments, and to assess performance and evaluate programs.

Second, sound financial management controls include safeguards to better ensure that funds are expended for their intended purposes. These controls identify what was purchased and the quantities purchased before payments are made. As such, adequate financial management controls discourage and prevent fraud, waste and abuse.

Third, dependable financial operations support our troops. Accurate and timely payments to the contractors and vendors with whom we do business better ensures goods and services will be available when and where we need them. Equally, or perhaps more important, 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 their home.

FINANCIAL MANAGEMENT REFORM HAS CONSTRAINTS

Financial management in the Department of Defense is a work-in-progress designed to fulfill the needs of its leaders, meet statutory requirements, maximize efficiency and minimize fraud. There have been notable successes, but progress is slow in some areas. It is impossible to reverse decades-old problems overnight and some reforms will require several years to implement.

In moving forward, the Department's financial management reform must accommodate three unavoidable constraints:

First, the Department cannot stop its financial operations while it fixes outdated business practices and flawed systems. Every day, the Department must manage payrolls, pay contractors, and produce financial reports. These daily operating requirements impose a strong practical constraint on our plans for improving systems and business practices. 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 manages over a trillion dollars in assets and maintains hundreds of bases in over 100 countries and territories throughout the world. We have over two million active duty and reserve component personnel as well as 700,000 civilian employees. The size of the three Military Departments of the Department of Defense--Army, Navy and Air Force--collectively dwarf the largest organizations in the private sector as well as all other federal agencies. The size and complexity of the Department makes changing the Department's financial management a significant challenge. However, it is a top priority, and we have made enormous progress.

Second, lasting reform demands consensus and collaboration. Few solutions rest exclusively within the jurisdiction of the financial management community. 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 non-financial "feeder" systems and accounting systems (for example, property and inventory systems that feed information to accounting systems) is a Departmental goal and is necessary to enhance the sharing of information and to avoid redundant and sometimes conflicting data.

Third, legislation in the 1990's has changed the Federal Government's accounting requirements. More recent legislation requires audited financial statements from federal agencies. 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 rely solely 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 was paid for it and produce the original receipt;

track where it is being used; 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 disposal or sale. Obtaining a clean financial opinion requires an integrated and complete audit trail for millions of DoD items, many purchased decades ago.

The Department's current leadership is committed to making financial management reform a hallmark of its stewardship. Progress to date has been substantial, and the Department is determined to successfully complete this historically significant reform effort.

PROGRESS ON FINANCIAL MANAGEMENT REFORM

Our 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. As the largest finance and accounting firm in the world, the DFAS now processes a monthly average of nearly 10 million payments to DoD personnel; 1.2 million commercial invoices; 600,000 travel vouchers/settlements; 500,000 savings bond issuances; and 122,000 transportation bills of lading, with monthly disbursements averaging $24 billion. Given the magnitude of these operations even a small percentage of errors can result in large numbers.

When the Military Services turned over their finance and accounting operations to the DFAS in 1991, they also turned over numerous problems that they had been dealing with, some allegedly since the formation of the Continental Army. In response to the many problems, we have undertaken the most comprehensive reform of financial management systems and practices in the Department's history. 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. Let me discuss some of these accomplishments.

Consolidation of Financial Management Operations

The DFAS is consolidating over 330 financial management field sites scattered throughout the world into five centers and 20 operating locations, saving $120 million annually. Through these consolidations, the Department is able to eliminate redundancy and unnecessary management layers, facilitate standardization, improve the accuracy and timeliness of our financial operations, enhance service to customers, increase productivity, and provide better financial management support to the Department's decision-makers.

Consolidation of Finance and Accounting Systems

To remedy the problem of numerous, incompatible and noncompliant finance and accounting systems, the DFAS has embarked on a major streamlining effort of our financial systems. As of October 1998, 109 finance and accounting systems were operating--down from 324 systems in 1991, a 66 percent reduction. Finance systems have been reduced from 127 to 18, with a goal of dropping to just 9 by 2003. Accounting systems are down from 197 to 91, with a goal of 23 or fewer by 2003. By the year 2003, the Department expects to pay and account for its over 2 million service members, 2.2 million retirees and annuitants, over 600,000 civilian employees, and 200,000 contracts using just 32 finance and accounting systems--a 90 percent reduction.

These system objectives compare very favorably with the private sector. A recent study of the number of finance and accounting systems used by the Top 10 Fortune 500 companies showed that, on average, each of these companies has approximately 147 finance and accounting systems--compared to the 32 planned for the Department. Further, not one of these companies had ongoing initiatives on the same scale or magnitude as the Department of Defense.

The objective of the Department's initiative, however, is not simply to reduce the number of the financial management systems. The consolidation, standardization, and modernization of the Department's financial management systems is meant to enable the Department to eliminate its outdated noncompliant financial management systems and replace them with financial management systems that provide more accurate, timely, and meaningful financial management information to decision-makers. These efforts also are producing other benefits, such as improved processes and significant cost savings.

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 without a degradation in services provided.

Between FY 1993 and FY 1999, personnel levels that the DFAS inherited from the DoD Components should decrease by 38 percent, from 31,000 personnel in FY 1993, to approximately 19,000 personnel by the end of FY 1999. By FY 2003, it is projected that the DFAS will reduce its personnel levels by another 3,000 personnel, to 16,000. Thus, over the ten-year period from FY 1993 to FY 2003, the DFAS will have achieved a 48 percent reduction in its personnel levels.

In terms of constant dollars, DFAS' cost of operations has decreased from approximately $1.8 billion in FY 1995 to a projected $1.6 billion in FY 1999--almost a 13 percent reduction. 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 industry average of 1.2 percent. These savings in

operating costs are being offset, in part, by the need to invest in new systems and technology in order to meet today's new requirements and challenges.

Outsourcing

Competition within the government and with the private sector also has been utilized to improve financial services and save money. Changes implemented by the DFAS, as a result of competition studies, have produced annual savings of $23 million through the streamlining of administration operations, facilities, logistics, and the consolidation of debt and claims management and vendor payments. Other reforms to the contractor payment and audit process have helped increase the accuracy rate of payments, expedited the settlement of overhead rates and the closeout of contracts, and are playing an instrumental role in the initiative to improve the procurement process, with a goal of becoming paperless early in the next century.

We also are using public-private competition (the A-76 process) to improve functions and reduce costs. Within the financial community, we have on-going A-76 studies in several critical areas, such as Defense Commissary Agency accounting, transportation accounting, depot maintenance accounting, and civilian and retiree/annuitant payroll.

To date, approximately one-third of the DFAS operations, measured in terms of costs, have been either outsourced, competed for outsourcing, or are in the process of an outsourcing competition.

Financial Management Policies

The Department is replacing approximately 70,000 pages of separate, and often conflicting, Defense organizational regulations with a single standard "Department of Defense Financial Management Regulation." To date, approximately 31,000 pages have been eliminated. In order to ensure the widest possible distribution of the policies contained in this regulation, the regulation has been made available on the Internet and on CD-ROM.

In addition to consolidating and eliminating duplicate and conflicting guidance, the Department also has promulgated more stringent and responsible guidance in a number of financial management areas. Such policies include, but are not limited to: (1) requirements to establish obligations for unmatched disbursements, negative unliquidated obligations and in-transit disbursements; (2) the requirement to record obligations in the official accounting systems within 10 days of incurrence; (3) the establishment of DoD Component responsibilities and requirements for reconciling contract payments; (4) the requirement to review and validate obligations at least three times annually; (5) the requirement to cease payments should accounts go in the red; (6) the requirement to implement the United States Government Standard General Ledger structure; (7) the requirement to prevalidate payments at levels below those required by

statute; (8) the establishment of rules for and responsibilities of the DFAS and the DoD Components for the preparation of various financial reports; as well as other policies.

Internal Controls

To strengthen internal controls, the Department implements checks, balances, and approval requirements for transactions that affect resources. Internal controls minimize the Department's susceptibility to mismanagement within its finance and accounting operations. The Department strives to incorporate the appropriate levels of verification without requiring excessive resources or hampering the ability to complete the mission.

Over the past 12 months, we have taken significant actions to improve our internal controls, including:

- Enacting a 100 percent review of our vendor pay systems to determine who has access and at what levels, ensuring that the necessary separation of duties exists;
- 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 is the creation of Operation Mongoose 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 Inspector General's Office, including the Defense Criminal Investigative Service, to develop fraud indicators that can be spotted by discrepancies among systems. This program collects and compares data throughout the Department, detects the presence of anomalies within the Department's systems and examines appropriate records to determine if applicable anomalies are a result of fraud. If fraud is found, the Department vigorously pursues criminal charges against those 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. Operation Mongoose has identified and recovered $20 million in erroneous, duplicative, or fraudulent payments. Despite isolated occurrences, we are succeeding in closing the door on fraud.

Disbursements

A problem disbursement occurs when an expenditure has not been reconciled with official accounting records. DoD problem disbursements, once totaling $34.3 billion, have been reduced to $10.9 billion as of February 1999. Although the Department

considers its problem disbursements a matter to be taken seriously, almost all such expenditures involved were proper and were made only after a Department official confirmed that the subject goods or services were received and that payment was in accordance with a valid contract. That notwithstanding, the Department has extensive efforts underway to improve its disbursement process.

Prevalidation, the process of matching a disbursement to an obligation before (rather than after) a payment is made, has helped to reduce problem disbursements. Thresholds for applying prevalidation have been established at each DFAS center. To assist in reducing problem disbursements, thresholds for applying prevalidation are being gradually lowered until all payments will be prevalidated.

In addition to prevalidation, the Department currently is implementing a system called the Defense Cash Accountability System (DCAS) that will automate the interservice disbursing process. When fully implemented, the disbursement voucher data will be collected electronically under one central system and distributed electronically to be available for posting to the accounting systems. The cycle time will be reduced from over 90 days to 2 days. The first phase of DCAS implementation began in March 1999 and DCAS is expected to be fully on-line by the end of 2000.

To assist in better understanding problem disbursements, attached are answers to frequently asked questions about problem disbursements.

Information Infrastructure

The DFAS is establishing a Corporate Information Infrastructure to support the use of common data elements for the collection, storage, and retrieval of finance and accounting data; support the use of common transactions; and support the movement of common transactions and data among systems. This reform is an ambitious effort to standardize and electronically share acquisition data between the acquisition and financial management communities. This effort will greatly improve the interactions between DoD procurement systems and the financial systems that process and account for the payments of the Department's acquisitions.

The DFAS also is working toward ensuring that all its systems are Year 2000 (Y2K) compliant. The overall goal has been to provide a coordinated effort that ensures no DoD financial management system is adversely affected by Year 2000 problems. Consolidation of the Department's finance and accounting systems has substantially reduced the cost of fixing the Y2K problem. The DFAS is on track to complete all Y2K-related programming for its finance and accounting systems, including the platforms, or hardware, on which these applications operate, and is expected to be fully Y2K compliant by May 31, 1999. The financial management community also is working diligently with the other functional communities to ensure incoming data streams are compliant as well.

Exchange of Financial Information

In addition to consolidating operations and reducing systems, the Department's financial management community has over 150 initiatives underway to improve and streamline financial management and improve the timeliness and accuracy of its accounting data. For example, the DFAS is promoting the paperless exchange of financial information through Electronic Document Management, Electronic Funds Transfer, and Electronic Data Interchange initiatives such as:

- Electronic Document Management World Wide Web applications. Electronic document access enables on-line, real-time access to documents needed to perform bill paying and accounting operations. This allows for contracts, government bills of lading, and payment vouchers to be stored in electronic file cabinets and shared between DFAS activities. Another application avoids unnecessary printing of reports by converting them into electronic format for on-line analysis, reconciliation, and reporting. Electronic data access 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.
- Electronic Funds Transfer (EFT). EFT is reducing the cost of disbursements. Over 98 percent of DoD civilian employees and military members paid by DoD have their pay directly deposited into their accounts. The direct deposit participation rate for travel payments is now over 90 percent. In 1998, 74 percent of the number of major DFAS contract payments, accounting for 89 percent of total contract dollars disbursed, were made by EFT. This percentage is expected to continue to increase.
- Electronic Data Interchange (EDI). The DFAS is using EDI to send remittance information directly to vendors and currently is working to receive and process EDI contracts and contract modifications into finance and accounting systems.

FUTURE PLANS FOR FINANCIAL MANAGEMENT REFORM

The 1998 Financial Report of the United States Government (formerly known as the Consolidated Financial Statements of the U.S. Government) was released on March 31, 1999. The Congress and the Administration initiated the development of this financial report in order to create an additional tool for policy-makers and to provide an additional source of financial information for the public. The publication of this second annual financial report represents one component of the Administration's continuing efforts to improve the management and efficiency of the United States Government, and to provide the American public with information about their government's assets, liabilities and operations.

Earlier in March 1999, the Department released its financial statement. In fact, the Department released eleven separate financial statements. These included separate

financial statements for the Army General Funds, Army Working Capital Fund, Army Corps of Engineers Civil Works Program, Navy General Funds, Navy Working Capital Fund, Air Force General Funds, Air Force Working Capital Fund, Defense Logistics Agency Working Capital Fund, Defense Finance and Accounting Service Working Capital Fund, Military Retirement Trust Fund, as well as an overall statement for the Department as a whole. Of these eleven statements, the auditors said that only one--the Military Retirement Trust Fund--was sufficient to earn a "clean" audit opinion symbolizing that the amounts reported meet acceptable auditing standards.

The results of these audited financial statements indicate that there is a need for further improvements in our financial management. To build on the progress to date, and to continue to improve DoD financial management, the Department must vigorously advance both a long-term and a short-term strategy.

Long-Term Strategy

Our long-term strategy recognizes that a lasting effective financial management reform solution requires a Defense-wide management information overhaul. This is necessary because our systems currently are not up to the task. Over the last few years, the Department streamlined its numerous incompatible finance and accounting systems by eliminating over 200 systems that did not comply with current accounting standards. More recently, the Department has been developing an architectural blueprint for Defense financial management reform and, in the fall of 1998, presented the first comprehensive "Financial Management Improvement Plan" for the Department. The plan touches on almost all aspects of accounting and finance within the Department. It includes, for the first time, an accounting and finance concept of operations that describes the manner in which the Department intends to carry out its accounting and finance operations in the future, and is a major step in meeting our financial management reform objectives. Our long-term strategy focuses on reengineering or replacing existing systems with systems that are compliant with new federal accounting standards and that will interface well with the Department's other financial and non-financial systems. Our objective is to transform our accounting systems and the many feeder systems that support them, with FY 2003 as our target date for completing the overhaul of our accounting systems.

Achieving accurate and acceptable financial management reports requires enormous efforts from all functional communities within the Department--not just the financial management community. Only 20 percent of the data needed for sound financial information originates in systems under the control of the financial management community. The remainder originates in non-financial feeder systems--most notably logistics, acquisition, personnel, and medical systems. Therefore, much of our effort must, and does, involve working with those other 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.

The "Financial Management Improvement Plan" that was submitted to the Congress last fall was only the first step. The Department intends to expand and refine the plan and continue to update it on an annual basis. The plan was developed to do more than just meet various reporting requirements. The Department fully intends to use the plan to guide the transition and evolution of its financial management improvement initiatives.

Short-Term Strategy

While system changes are the long-term solution, there is much that we can, and must, do between now and FY 2003. Our short-term strategy recognizes that. We are developing interim methodologies that will allow the Department to achieve a satisfactory level of compliance in its major accounts and attain 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 are working, on a collaborative basis, to identify major obstacles that must be overcome for the Department to be successful; developing interim solutions to the Department's systemic problems; and applying accounting and auditing standards in ways that make sense for the unique requirements of 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 ensure we stay on track, applicable organizations within the Department are being asked to report on their progress, and, as appropriate, update these plans on a regular basis.

The Department has hired contractors (CPA firms) to assist in its efforts. The Department also is developing more detailed policy guidance to assist the various DoD Components in identifying and reporting additional information not previously required. Further, the Department is examining various internal processes to identify gaps or deficiencies in its current information flow processes and developing interim approaches to overcome those deficiencies pending the modification of existing systems and/or the introduction of new systems.

For example, one short-term strategy involves reporting the value of property, plant, and equipment. The GAO estimates that the value of the property owned by the Department is four times the value of property and equipment owned by the rest of the Federal Government combined. Stated differently, the Department of Defense has approximately 100 times more property than the average federal agency. As a result of new government-wide standards that became effective in FY 1998, the Department now is being asked to report a value for this general property, plant, and equipment that is

based on the initial purchase price, and record depreciation for the asset since the initial acquisition date. The problem is that much of this property was acquired decades ago, some over a century ago, and many of the original documents needed to substantiate the initial acquisition cost of these properties no longer are available. Therefore, we are working with the auditors, and have hired private accounting firms, to develop an acceptable method for establishing a value where adequate documentation does not exist.

Another action involves quantifying the Department's long-term future liabilities, such as projected future costs of health care for current and future Department of Defense military retirees, projected future environmental cleanup costs of Defense properties, and projected future disposal costs of weapons and hazardous materials. These are liabilities that the Department may not be required to pay until 10, 20, or 40 or more years in the future, and that, until recently, the Department was not required to report. Clearly, it will be a difficult task to identify and report the amount of these long-term future liabilities. But, it is the right thing to do, and we intend to do it.

FINANCIAL MANAGEMENT TRAINING AND PROFESSIONAL DEVELOPMENT

The challenges that I have discussed with respect to improving our financial management processes and systems are enormous. Moreover, these challenges coincide with a period of considerable turbulence, as we face continued downsizing and turnover. To respond to these challenges, the Department is placing an even greater focus on training and professional development.

Today's financial management workforce is well qualified and highly motivated, but tomorrow's must be even better. We need to prepare the next generation of financial management leaders. To that end, we are developing professional standards for our financial managers. Such standards include recommended education and training requirements, participation in continuing professional education programs, and perhaps some form of professional certification. Our goal is to ensure that as individuals are promoted, they attain and exceed desired core competencies in financial management.

The pursuit of desired professional standards would help better ensure that we can continue to produce high quality financial managers. It also would demonstrate quality in an objective and measurable manner that would be visible both 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 for the Department as a whole.

CLOSING

From the President on down, the Administration has demonstrated that it recognizes the importance of sound financial management practices. Within the Department of Defense, we recognize the extent and severity of financial management deficiencies and the need to address these deficiencies. This requires a concerted improvement effort across the entire Department, not just the financial community. Given where we were in 1991, and the obstacles we faced, the progress we have made so far has been extraordinary. Notwithstanding the formidable nature of our remaining challenges, we have set a high, but achievable, objective for ourselves, and we will continue our efforts to correct weaknesses and improve the reliability of our financial information. We look forward to continuing to work with this Congress to achieve the goals and objectives associated with financial management reform efforts.

Mr. HORN. Well, we thank you. I don't envy you your responsibilities. And I appreciate your statement.

We're going to allow 10 minutes to each Member for questioning. We will alternate, and the chairman's time will go to Mr. Ose for 10 minutes and then the ranking member, Mr. Turner, and then the vice chairwoman, Mrs. Biggert.

So, Mr. Ose, 10 minutes on questioning.

Mr. OSE. Thank you, Mr. Chairman.

My questions are primarily directed to Mr. Dodaro. I have read your testimony. I have a couple of questions. I think they boil down to really a concern on my part as highlighted on page 15 and 16, regarding training of personnel, page 15 at the bottom and page 16 at the top.

There is a comment in there, "It is essential that DOD also establish a well-trained cadre of financial management personnel. "And at the risk of cherry-picking this testimony, I'm going to hop forward a couple of paragraphs, where it also makes the comment that over half of those surveyed had received no financial or accounting-related training during 1995 and 1996.

First of all, the DOD has a cadre—I hate that word—but a group of accountants that it uses to establish the books. Do they come out of the military? Do they come out of military training? Do they come out of business school? Where do these folks aggregate to us from?

Mr. DODARO. Yes. Most of the accounting technicians are from the civilian work force. Part of the issue here—and really this is an issue across the Federal Government, but it's most acute in the Department—is that in many cases, the accounting functions could be best described as administrative backwater functions over the years. This occurred until there were requirements to prepare financial statements which started in fiscal year 1996, which was the first year these requirements were in place across the government.

So there were in place a lot of technicians or clerks, voucher-processing people, and really there was not a great deal of attention given to training of those people over time, which was our point to the Department. We went out and we compared the type of training activities that occur in leading organizations in the private sector and in State governments, where they have had audited financial statements for a number of years, and good financial management operations, and we asked, "How much do you devote to training?"

And they came back and said, we devote quite a bit of effort, resources and time to do that. We believe, unless there's minimum training requirements established and a training curriculum put in place for the Department, that there's going to be continual difficulties. Part of the recurring audit problems, Congressman Ose, largely revolve around failure to follow established procedures that are in place, not doing these monthly reconciliations that I mentioned at Treasury Department. So training is really important.

And I understand that the Department has been reluctant to set minimum requirements then that implies a resource commitment to this organization of people to bring them up to the level in which they're been held accountable now. And that's really important.

Mr. LYNN. If I could jump in.

Mr. OSE. Mr. Secretary.

Mr. LYNN. I think what Mr. Dodaro said is true. In the past we have been reluctant to set standards. In fact, we are now undertaking an effort that would set standards and certification to those standards.

Mr. OSE. For the personnel?

Mr. LYNN. For the personnel. We set up a new school in Massachusetts with the curriculum toward this end. We're working with the American Society of Military Comptrollers in terms of an effort to do that certification, to have an objective set of criteria by which to judge people. And we agree with Mr. Dodaro that more efforts need to be put into training. That's actually not, I think, limited to financial management. I think that's government generally.

One of the things that we've found, in general, is that the Federal Government does not spend nearly as much on training its people as private sector people, private sector companies do across the board. And the Secretary is committed to improving that across the board, and we've taken steps in the financial management area in particular.

Mr. OSE. As a freshman I would hasten to add, I wish they would have some congressional training for Members, but it's not just on that side of the table.

Mr. DODARO. Congressman Ose, one of the things we point out in those paragraphs that you're citing is that there's a well-defined program that has been put in place in the acquisition community in the Department of Defense, because there has been problems over the years and because of the billions of dollars that that organization handles, now there's certification requirements and training programs; and we think the same level of effort needs to be given to financial management. So I'm glad you raised that question.

Mr. OSE. I don't know how to handle a problem unless the person handling it is well trained. You can see how I'm flailing about up here. I can imagine how it is out there.

I do want to note that there's a couple of spots under the short-term improvements notation in some of these paragraphs where accounting standards are in the process of being implemented. I specifically want to go to the citation on page 9 related to the Air Force in differentiating between national defense assets and property plant and equipment. This indicates that we're in the process of implementing that. I would appreciate a status report if anyone has information as to however along that is.

Mr. DODARO. Sure. The basic standard changed abit for fiscal year 1998. Let me back up and explain the way that standards are set. There's a Federal Financial Accounting Standards Advisory Board that has been created by the Director of OMB, the Secretary of Treasury and the Comptroller General, and they recommend standards to OMB and GAO and then they're adopted and put into effect.

One of the fundamental issues that they've been focusing in on is while they use commercial accounting standards to the extent they make sense for the Federal Government, is to really tailor the standards to the unique requirements of the Federal Government.

Nowhere is this more applicable than in the national defense arena, where you really don't always have comparable standards. This area is very unique.

So the requirements for 1998 were to take mission assets, weapons systems, et cetera, off the balance sheet because everybody agreed it didn't make any sense to depreciate carriers over a period of time. The change put them in a separate stewardship statement, whereby there would still be accountability for quantities of those assets, have some information on the level of investment that we're making as a country in weapons systems development, and there would be responsibility for tracking additions and deletions over time. And that standard is still under review as to exactly what type of reporting would best be useful to the users of the financial statements.

But the basic idea was to treat mission assets differently than you would treat the buildings used on bases in the normal support, real property, land and buildings and personal property, desks, computers, et cetera, that carry out normal business functions. And the Department is in the process now of separating that out. There are some gray areas, obviously.

Mr. OSE. How far along is the separation?

Mr. DODARO. Let me ask Ms. Jacobson to answer that. And I'm sure the Comptroller's office has some information on it.

Ms. JACOBSON. They basically have just begun going through the individual kinds of assets and trying to separate them between the various categories, between weapons systems and other types of property. Part of that is because the definition did change under the standard this year, to try to clarify some ambiguous items. So they are in the process. They are working on it, and they do have contractors involved trying to help them do that.

Mr. OSE. If I may, one thing I always like to do is I always like to do something small and then expand it, if it works. Are there any departments or—that's not the right word—subdepartments of the DOD where your review has shown things to be properly accounted for that you have a high degree of confidence in the reports that you submit?

Mr. DODARO. Basically, the Military Retirement Trust Fund has received a clean audit opinion from the audits done by the Inspector General. The various services are at different stages of development. Under the original Chief Financial Officers Act that passed in 1990, the Department of Army and the Department of Air Force were designated pilot programs and audits were done. So they've undergone audit scrutiny for a longer period of time and are moving to correct some of the weaknesses.

But by far, the service that needs the most work is the Department of Navy. And I know there are different levels of effort that's going to be required to bring up different parts of DOD. But the only one so far in the major parts of DOD to get a clean opinion is the Military Retirement Trust Fund.

Mr. OSE. Does that include the post-retirement medical—because I saw in here there's 200—an estimate of $223 billion in actuarial liability.

Mr. DODARO. No, that does not include that, and that is still an issue which we raised on the consolidated financial statements of

the Federal Government. On the civilian side for the fiscal 1998 statements, problems were rectified by changes that OPM put in place. But on the military side, the post-retirement health care benefit still needs work to determine a better basis for making the estimates, having actual claims data, documentation, et cetera.

Mr. OSE. Mr. Chairman. If I may, I would like to submit questions for followup. Just the observation that I've got is that—I mean my business was very small and it was no grand enterprise, by any means. But I always figured that if I could get one thing under control and keep it there and move to the next thing where it was screwed up, if it was, and correct that and keep moving across the board, we could always get to the end at some point in the future where we knew things were right.

That's why I asked the question about the retirement system. If that's fixed, let's not take our eye off the ball there. Let's move to another segment, fix that, if we can, and keep moving through. So I thank you for the chance, and I will submit questions.

Mr. HORN. I agree with the gentleman. And the questions and the answers from the various witnesses will be put in the record at this point, without objection.

Now I yield 10 minutes for questioning to the ranking minority member on the committee, Mr. Turner of Texas.

Mr. TURNER. Thank you, Mr. Chairman.

One area that I wanted to inquire a little bit into in the prepared testimony that was submitted today related to improper contract and vendor payments. You know, this just almost boggles the mind to read that particular section of the report.

It says the DFAS Columbus Center received in return payments from defense contractors $4.6 billion. Between 1994 and 1998 those return payments were due to overpayments to contractors. It's just beyond me to understand how that much in overpayments could be made to contractors, and you have to try and get it back and you wonder how much more is out there that you didn't get back.

It would be helpful if you can explain to me how in the world that kind of situation exists. I mean, are contracts all that complex that we just—that they can't even administer them properly and everybody is having to go back and check on whether they've got the right amount of money?

Mr. DODARO. Basically, there are a couple of fundamental problems. No. 1, many of these contracts are complex. They're modified many times over a number of years, and there are countless amendments. And some of the files and contract files that DFAS Columbus require—in fact, reinforced floors to hold the size of some of these contract files.

So contract administration is complex. When contractors return payments on their own; a lot of these cases the contractors are just sending back voluntarily overpayments, in addition to those found by the Defense Contract Agency. Part of the problem stems from the fact that a large part is contract administration errors that occur along the way, and then there are payment errors.

This problem, Congressman Turner—if you remember when we were talking about the consolidated statements of the Federal Government, we mentioned the Medicare area where there were a lot of improper payments made in the fee-for-service program. A lot of

this stems from the fact that over the years the primary measure of performance for a lot of financial management functions were how quickly you could get the payments out, in this case, to the DOD contractors and other cases the Medicare service providers.

So there was pretty much a pay-and-chase mentality in place over time, as you get the money out quickly, and then you sort through the process through a post-audit evaluation, which is why the Defense Contract Agency has been set up. And that is not a good way to run a business. I mean, it's not a good internal control to rely on the people you're paying to voluntarily send money back to you if they're overpaid.

So DOD started to validate some of the material beforehand. But part of it also stems from the fact that the contract payment process is different than the accounting process. And so the payments are made, and then it takes a while to match up. This is where the systems problems are really problematic, because they have no ability to compare and reconcile the information to know that the goods were received and also that it was a valid obligation.

So this is a fundamental area that needs reform. And you're putting your finger on a proper issue. It's a fundamental problem. And it's been in place for a while. The Department is trying to address it, but until they reform and bring the contract community together with the accounting community—and this is another area where you have diffuse responsibilities within the Department—and really have a good check and balance in place on those payment systems to make sure that only proper payments go out the door, this is going to continue to occur.

Mr. LYNN. Mr. Turner, if I might just jump in. One of the challenges we have in the Department of Defense is that any number that involves the Department of Defense is going to be huge, which is a two-edge sword. It means that we have to redouble our efforts to make sure that we're—we have the right controls in place, because so many dollars are involved.

It also means that any example that you cite is going to have a large number associated with it. The number you've cited is coming down. We've cut contractor overpayments in half over the last 3 years. So it's down. Just to give you an example of what kind of magnitude, it's about one-tenth of 1 percent right now. But that still gets you up into the hundreds of millions of dollars, which is still too large. And Mr. Dodaro is exactly right. We need—and we are taking the steps which involve electronic data transmission, electronic commerce, that will link up the systems to avoid any of these overpayments.

But I don't want you to leave the impression that this is a large portion of our dollars. It is a small portion, and it is declining.

Mr. TURNER. Well, just if my math is correct, it looks like we have to return about $2 million a day to Defense contractors or they have to return to us about $2 million a day. It just seems like an awful lot of money to me.

Mr. LYNN. You're making my point; just about any level of the Defense Department has a lot of money.

Mr. TURNER. It seems to me that, you know, maybe it goes to the complexity of the contract arrangements; maybe it's inevitable that there is going to be some confusion in it. One thing I noticed under

the section labeled "improper contract and vendor payments," in the first paragraph you refer to the $4.6 billion that is returned over that 5-year period by Defense contractors; and then down in the third paragraph on page 19, we're talking about $6.8 billion. I'm not sure I understand the difference in those two numbers.

Mr. DODARO. The $4.6 billion is what the contractors returned on their own voluntarily. The $6.8 billion is what the Defense Contract Agency disallowed through a post-audit function, where they're reviewing all the contract documents on the payments and they disallow some costs. So the $6.8 billion is what DOD identified on its own through the contract agency and settling out a contract. Any time a contract is closed, it's then audited by this contract agency. So those numbers are mutually exclusive.

Mr. TURNER. And, Mr. Secretary, the numbers you were mentioning that have improved, are those the voluntary repayments or the amount that we've actually recovered through efforts of the Defense Department?

Mr. LYNN. The numbers I was referring to was the first set that you referred to, which are in some voluntary overpayments, others are overpayments that we find ourselves as we go back and research the payments. It's a combination of both of those.

Mr. TURNER. So you can't tell me what percentage of the improvement is represented by increased voluntary return from Defense contractors versus the percentage that we have recovered because of our own Department of Defense initiative?

Mr. LYNN. Oh, no, I can tell you that. Almost all of the improvement stems from improved systems and better linkages between our disbursement activities and our accounting activities. It doesn't represent an increase in voluntary payments.

Mr. TURNER. Is there any way—and I guess you have to be pretty close to all of this to understand this very well—but is there any way to know how much more we should be recovering? These are large numbers to me, and you say it's improved in terms of repayments from Defense contractors. But is this sort of a tip-of-the-iceberg sort of the problem, or does this represent just the way the system works and we're probably getting back all that we're supposed to get back?

Mr. DODARO. It's difficult at this point to really tell until there are thorough audits done on a statistically valid basis to look at total disbursements. As we point out in here, there are other problems with disbursements that are made that are not matched to obligations for a long period of time.

And so part of the problems that the audit community have been identifying we really have not gone in and taken like we have in the Medicare program, as we explained to you before, a nationwide sample of claims and come up with a number of improper payments, so that those can be tracked over time. That has not occurred yet at the Department of Defense.

And at some point in the future, when the records can be in a little bit better shape, that needs to be done; and then you would have the figure that you're talking about. So you would really know the magnitude. These are anecdotal examples at this point and not based on a statistically valid sample of all the disbursements at the Department.

Mr. TURNER. What would it take to do a statistical-analysis sampling to really—I mean, is this really a big undertaking to do this?

Mr. DODARO. It would be a significant effort. But right now, it's not worth the resources, because there are so many fundamental problems and the lack of documentation. In some cases, some of these disbursements are researched for 4 and 5 and 6 years before they're matched with the disbursement with the obligation. So some of the records—the fundamental recordkeeping is problematic—that's why I mentioned getting the existing systems better in shape and the reconciliations that need to be done. Those things need to be done first and narrow this problem.

Because you could do a statistical sample, but in most cases what you would find is that perhaps the documentation is not available to make a conclusion one way or the other. So our judgment at this point is that it wouldn't be a prudent use of resources until we can get some more fundamental improvements in place at the Department. But once that has occurred, through use of the proper statistical-sampling techniques, you should be able to do this.

Mr. TURNER. Thank you.

Mr. HORN. Ms. Jacobson, you had to really work on that audit. Do you want to say some things in response to Mr. Turner's questions?

Ms. JACOBSON. Well, I would just add to Gene's comments that we did do some testing of those MOCAS disbursements out of Columbus this year; and one of the things that our preliminary findings show is that about half of the total dollars in transactions are adjustments. Some of those go back for 24 years adjusting the accounts to reflect what happened when that disbursement went out the door. So it's a very messy system in process right now. And it's going to take a lot of effort to clean up.

Mr. HORN. That was Mr. McNamara's beat, 1965.

Mr. MANCUSO. Mr. Chairman, if I might, I would add that from the Inspector General's perspective, there have been any number of occasions over the last several years where the Department has recognized that a particular contractor or an individual may have received what appeared to be duplicate payments or excessive payments and for whatever reason has not acknowledged that and in some cases denies it when confronted.

Just as a matter of course, the Department relates that information to the Inspector General's office, and we pursue those matters as potentially being fraud against the Department. Although in numbers, these are very few compared to the overall numbers of instances of overpayment, we have found on occasion that people have deliberately double-billed the Department because they suspect there may have been a weakness in the accounting system.

Or in other cases, unfortunately, there have been times when people internal to the Department have generated payments through the payment offices in a roundabout way, moneys that would come back to themselves or associates, again taking advantage of the poor controls in the systems that we currently have.

So there has been a somewhat good relationship with the Department and the IG's office in trying to ferret out these anomalies where it is just not a simple mistake in overpayment or a mistaken

act by a contractor in accepting an overpayment. But overall, those have been relatively few.

Mr. HORN. In our first hearing on this, the figure was, and we sort of looked at it with certain bemusement, the same outrage, in a sense, that Mr. Turner has and, that is, what has the Pentagon done with $25 billion that we can't find? We asked Mr. Hamre at that time, the Assistant Secretary. I think it was your job, and yours has a new nice title to it, Under Secretary.

We did another hearing, and we were told it is down from $25 billion that we can't find to $10 billion that we can't find. I think that figure was used today in the testimony. Is it basically just a problem of acquisition, contracts, and inventory that we can't seem to match up somewhere? Again, a lot of it was the Columbus, OH, processing center.

We even heard there were such things as general schedule 1 still around. I thought they went with the first world war because I actually knew a GS–1, an administrative Assistant Secretary who worked his way up the whole hierarchy when it was GS–1 to GS–18. Have they cleaned up that situation?

Mr. LYNN. Maybe I can help with you that one. The $25 billion and the $10 billion numbers that you were referring to is actually not money that we can't find. We can find the money. The issue there is the paperwork. What you are looking at—those are what is called the problem disbursements. The problem there is that the paperwork is not all complete. There is some missing element. There are a variety of explanations for it. It can be a transposed set of numbers; it can be not being able to find the right obligation; it can be not being able to find the right contract. There is a whole series. Those take a long time and too long, as Mr. Dodaro indicated, to research and find. The vast majority, as Mr. Mancuso indicated, involved just lost paperwork and ultimately it is found. But the money is not lost. It is a problem in the paperwork.

The numbers that you cited going from $25 billion to $10 billion indicate the improvement in the systems that we have put into place. The systems are about two-thirds there. As we replace other systems, the MOCA system in Columbus that Ms. Jacobson was referring to is on the list to be replaced over the next year or year and a half. That will substantially help that area.

The prevalidation efforts that we are putting into place at this point will substantially help that. We are trying to drive this down, but it's a very large operation. I don't want to leave you with the misimpression that the money is lost or cannot be found. This is an issue of making sure that the paperwork is all up to date and matched.

Mr. HORN. Are you saying, Mr. Lynn, that the money has found the Defense Department, but the Defense Department hasn't found the money? Where is it in the pipeline?

Mr. DODARO. I am saying, for example, that——

Mr. HORN. Let's move that team that has got the retirement problem fixed up and move them over to the Columbus processing center if they are still screwed up.

Mr. DODARO. One of the ways that we have gotten the $25 billion that we inherited down to $10 billion is we have had tiger teams where we put the best people on it and drive these things down.

You are talking about going through warehouse after warehouse of information to try to find that right piece of paper that matches with the payment. It takes time. We are working our way through it.

Ultimately what you want to do, as I think that Mr. Dodaro and Mr. Mancuso indicated, is you want to have an electronic system so that you don't have to do that paperwork research, that the system itself is seamless, and that those matches are made electronically. We are working that. At the same time we are trying to work that backlog of unmatched disbursements down.

Mr. HORN. Any other comments? Mr. Lieberman has a comment.

Mr. LIEBERMAN. If I might, Mr. Chairman, make a couple of quick comments. We analyzed the problem disbursement situation in a report that we just issued on April 16, which the committee now has. I think there are a few basic points to make when we talk about contract payments.

First of all, Mr. Turner alluded to the way DOD contracts are structured in the first place. It is true that we have bewilderingly complex contracting which is something that the acquisition reform effort is trying to do something about. Second, we have to keep in mind that we are talking about tens of millions of transactions annually. It's imperative that we fix the process on the front end so that these payments are made right, rather than trying to audit fidelity back into the system afterwards, because there are just too many of them being made.

It's equally imperative that these disbursements be made by automated systems, because DOD just can't do tens of millions of transactions manually and have any hope at all of complying with the Prompt Payment Act. Therefore, we are back to systems as being the root cause. We have lousy systems. New ones are in the works and will be in place by, say, 2002. That's the long-term solution.

In the meantime, the Congress has legislated an extra step in the process which we call "prevalidation." Disbursements over $1 million are not supposed to be made unless the disbursement people know that they have a valid obligation already on the books to match against that disbursement. That's supposed to be an extra control.

The Department is trying to drive the prevalidation threshold down from the $1 million figure required by Congress all the way to a de minimus level of, say, $2,500, which would cover many more payments. But that's been terribly difficult because this is a manual process. We have been unable to get below the $500,000 figure and stay there because payments slow down. Contractors have a right to be paid if they provide services to the government. If they are not paid, they scream to the Department and to the Congress. This is a real dilemma over the next 3 years or so until we have these better automated systems in place. So it's a very tough problem.

Last, it's hard to judge whether DOD is making progress or not with problem disbursements, because we don't know what we don't know. The data that managers have in their systems is not particularly reliable to tell them what is going on and we have done limited auditing due to resource constraints.

Mr. DODARO. The parallel issue that needs attention at the same time that the Department is automating systems is to really fix some of the weaknesses in computer controls. The Department's computer systems are like a lot of Federal agency computer systems. I am talking now about unclassified systems which would include some of these payments systems as well as some logistics information. They have serious computer security problems that make them vulnerable, both to outside hackers getting into the system and as well as people within the Department or its contractors who have too much access.

Mr. Mancuso mentioned the number of reports that they have issued in that regard with recommendations. We have, at GAO made recommendations, and the Department is trying to put into place a comprehensive computer security program. But if that problem is not handled now with the existing systems, as the Department becomes more automated, that problem will become more acute and the Department will become more vulnerable.

So both things have to go in tandem: process reforms, upgrading the systems, and having the proper computer security controls in place to make sure that the systems are not exploited.

Mr. HORN. Anybody else want to comment on Mr. Turner's question? OK. Vice Chairwoman Biggert, 10 minutes questioning.

Mrs. BIGGERT. Thank you, Mr. Chairman. I think that the GAO reported that in the Department of Defense lessons learned and studies from operation Desert Storm, that better asset information could have saved over $2 billion and that the weaknesses in management control assets have been longstanding.

Mr. Lynn, will the Department experience any cost deficiencies in the current conflict in Kosovo as a result of the changes from the lessons learned in Desert Storm?

Mr. LYNN. I wouldn't be able to quantify that. We have improved our systems since Desert Storm. We have better total asset visibility. So what that will mean is the units in the field are better able to know when their munitions and other spare parts stocks are on the way so they won't double and triple order them. I think that was the problem referred to.

We think we have reduced that problem, which would imply some savings, but I wouldn't even try to quantify it. We have not licked that problem, though. In particular, we need better inventory systems in the logistics area, and we need a better connection between the inventory systems and the financial accounting systems. That interface right now is not adequate, and that's one of the reasons that we are not able to get a clean opinion. That's one of the four or five major deficiencies that we are focussing on with GAO, the IG, and OMB to try and better improve our performance there.

Mrs. BIGGERT. I think one of the problems that we are facing with a vote coming up is the fact that we don't have really the inventories and what is really the supplies and inventories that we need right now, over and above the bullet for bullet in Kosovo. So if you say that you don't know or have control over those assets, then it makes our job much more difficult.

Mr. LYNN. I'm not saying that we don't know and don't have control over the assets. We do have control over the assets. The issue

with regard to the vote that you are talking about, I think, is somewhat different. The kinds of things where we are proposing to replace right now are major end items like cruise missiles, JDAM bombs, Tomahawk cruise missiles, Navy cruise missiles. All of those, we have very exact controls. We know where all of them are. We know how many we need. We know how many we have expended.

The issue surrounding them has to do with where we are in production. For example, the JDAM is only in its second year of production. It is becoming the munition of choice because it's performed so well. But you obviously do not have very many if you are only in the second year of production. The proposal that is going to be before you this week would be to accelerate that production, to actually double that production because of the performance.

The cruise missiles are still a different story. The air-launched cruise missiles are actually older cruise missiles. They were nuclear. They were built during the Reagan administration. The line was shut down then. As the nuclear forces have been coming down, we have been converting those nuclear cruise missiles to conventional purposes. There is only so many that we can do that with. The long-term solution, which is not that long term, production starts next year on a new standoff attack weapon called the JASSM. The air-launched cruise missile is just an interim weapon.

Similarly with the Tomahawk, the Navy-launched cruise missile. The issue there is we are going into a production of a new system in 2003. The question is how many of the older systems that are not quite as good or quite a bit more expensive, how many of those do you want to keep as a bridge to the new system that starts production in 2003? The proposal that you have before you would increase that number because of the expenditures in Kosovo and Kosovo as well as Desert Fox.

Because we have shot those numbers at a higher rate than we anticipated, we now see a need to supplement the numbers we have between 2000 and 2003. In no case, though, here do you have an inventory problem with any of those systems.

Mrs. BIGGERT. Mr. Dodaro, could you comment on that? Do you think that there has been any significant change since Desert Storm?

Mr. DODARO. I would only say that I agree with Mr. Lynn's comment, that they haven't got the problem licked yet with the systems, and they will need to continue to work on that to get the integration between the accounting system and the logistic systems.

Mrs. BIGGERT. OK. Mr. Mancuso, in your statement, you point out that you believe that focusing primarily on the financial statement audit opinions may not be the best approach for the Department. We keep hearing about the clean audit, the clean audit. Could you expand on that a little bit?

Mr. MANCUSO. Yes. I think it's clear that despite our efforts and despite our work with the Department, at least many of us believe that the statement, for instance, for this year, which was a disclaimer, will probably be repeated next year, certainly on the consolidated statements and almost certainly on many of the other supporting statements.

We feel it necessary to keep working with the Department and with GAO and OMB on ensuring that the feeder systems get addressed, that the underlying systems receive the resources that they need to ensure continued progress so that eventually we can reach clean statements.

Even within our own organization, however, I would say that there is some debate as to how much of our resources need to be continued toward just achieving clean statements. By that I mean that, for instance, in the DOD IG's office, we spend about 200 audit work years solely on CFO work. That consists of close to half of our audit resources.

At the same time, for instance, we have no resources at all looking on the finance side of DFAS, where we know there are problems. Yet we continue to spend our 200 audit work years. To be fair, there is a very strong argument that could be made to say that we will never achieve clean statements if we let up the pressure, if we tried—for instance, an elementary suggestion would be, well, why can't we just look at them every other year if we already know what we are going to find next year? An argument could be made that that would lessen the pressure on certain leadership in the Department to achieve clean statements and to achieve the work that needs to be done on the underlying feeder systems.

So in sum, again, I guess our perspective would be that we see a greater good coming from resources being applied toward correcting the underlying problems and not in solely aiming toward clean financial statements which may, in themselves, disguise problems that still exist in the feeder systems.

Mrs. BIGGERT. Thank you.

Mr. DODARO. If I could add a couple of perspectives to that, the underlying law, the Government Management Reform Act, really requires annual audits to be done, financial statements to be prepared and audits to be done across the 24 departments and agencies of the Federal Government as well as the consolidated financial statements of the U.S. Government, which means that for the first time the Federal Government is now living by the rules that it sets through the SEC for publicly traded corporations. They have annual audits so the stockholders have good information.

Every State and local government in this country that receives over $100,000 in Federal assistance has to have an annual financial audit. But the executive branch of our National Government has not had that requirement in place until recently. We have seen other departments and agencies across the Federal Government begin to get their fiscal house in order only through this annual public scorecard.

We now have about half of the departments and agencies that get unqualified or clean opinions. It takes a number of years, but the annual requirement is paramount in our opinion, and also the measurement of progress should not be the overall opinion, but it should be how many deficiencies are identified in that opinion and are the departments making progress in reducing the number and severity of the audit deficiencies. As Mr. Lynn indicated, we are working on a plan with the Department that will be a better measuring stick of the Department's short-term progress.

Mr. LYNN. If I might add, I agree entirely with Mr. Mancuso. The audit opinion in and of itself is of limited value to the Department. We don't determine expansion as a commercial operation would be on a—we don't need a profit and loss statement for stockholders. The value for us is the state of our underlying finance and accounting systems and public confidence in our financial stewardship. Those are the purposes for which we would seek a clean audit opinion, which are considerably more narrow than a commercial operation.

Mr. Mancuso, I think, is exactly right. The goal needs to be to improve our underlying systems. If we are to get a clean opinion that doesn't improve our underlying financial systems, that is—that's meaningless. What we need to do is improve our overall effort in this regard, and the clean opinion should be a measure of our progress in that. That's its major value.

Mr. DODARO. I would agree with what Mr. Lynn is saying, but I would say that if a department or any organization cannot get their end-of-year financial data correct 6 months after the end of the financial year, there is no hope to have underlying data correct throughout the year. It's a starting point. It's not an end in and of itself, but a starting point to get year-end data correct so that at least you have annual trends that you can track over a period of time. It is a modest beginning, but it's a necessary one.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. HORN. Thank you. Did you get enough people answering that last question? It's a very important question, so let me pursue it a little bit. I will yield myself some time on this and then turn to Mr. Turner. Are the logistic systems part of the problem, the inventory controls and the interface with the financial systems? It seems to me that you have a product, you purchased it, it has a certain value on it, it is located in a certain place. Tell me how that works, Mr. Lynn, and how far along we are in getting those matchups?

Mr. LYNN. The logistics systems are indeed a problem, Mr. Chairman. One of the problems was alluded to in your question. You indicated they have a value. Actually, many of the logistics systems were not designed to do financial accounting. They didn't include a value. They were just for accountability purposes to track the equipment but not to track the value. In other cases, if they track the value, they are interested in the replacement costs whereas the auditors would be interested in the initial purchase cost and then to depreciate that.

Oftentimes the logistic systems do not actually have the right information for us to be able to get a clean opinion. We are taking steps and we are moving in the direction of putting—either replacing those systems or putting modules in those logistic systems that provide that information. And we are taking steps. The first major one was this financial management improvement plan to try to improve the interfaces between those systems and the finance and accounting systems.

Mr. HORN. Have you lined up different categories? And if so, give me some examples. I would think you are talking about the replacement costs of cruise missiles. Pencils, who knows what you are talking about on that one. Can you just show me a few different forms of logistic interface with financial management?

Mr. LYNN. You are getting into more of a detailed area that I think Mr. Toye would be better able to answer.

Mr. TOYE. Mr. Chairman, we have identified 83 critical feeder systems. These are the systems that are most essential to provide financial information to DOD to allow it to produce audited financial statements. We are focusing on each of those systems, identifying the information that we need from those systems, determining what the difference is between what is in there and what the needs are, and we are modifying the systems to get the information that we need.

One of those areas, for example, would be property systems. Another area would be medical systems. There are, within each of those categories, numerous systems that capture information. For example, in the property area there are multiple systems that took national defense weapons systems. There are systems that focus on real property. There are other systems that focus on what we call personal property which would include general equipment, vehicles, ADP systems and software. The problem in each of those systems is a little different. The overarching problem is the same, as indicated by Bill Lynn. Often those systems do not capture the value information that we need to report in our financial reports.

Mr. HORN. For most Members of Congress who are not on the Armed Services Committee or on the Defense Appropriations Subcommittee, it came as a tremendous surprise that we did not have a very good inventory of cruise missiles. We heard of a few Tomahawks floating around and a few cruise missiles turning around. It just seems to me that Congress would have been rather upset if they had known what maybe the Armed Services Committee did know but the rest of us didn't know.

When that word spread around here a few weeks ago that we were out of munitions, that came as a surprise to Members of Congress as a whole. Mr. Lynn.

Mr. LYNN. Let me be clear. We are not out of munitions, Mr. Chairman. As I said, there are certain interim munitions in which the stocks have been reduced. We have gotten proposals to restore those stocks. There are other categories of munitions such as laser-guided bombs which just came in at the very front end of Desert Storm. A few were used then. We now have tens of thousands of those.

It's when you—as you shift from one munition to a more advanced munition, there is a tendency to focus on the stock of the most advanced munition which will always be the smallest because you just started production. The munition just behind it, we have tens and tens of thousands. We are not running out of munitions, Mr. Chairman.

Mr. HORN. Now you noted that you have got—was it the JASSM missile?

Mr. DODARO. JASSM. It's a joint-air-to-surface missile.

Mr. HORN. Because I thought of tea when you first said it, and I also thought of a jazz man in New Orleans, and I wasn't quite sure what that was. Now we have gotten that straight for the reporter. Right now if somebody asked you what is your surplus in the Pentagon budget, could you give them a number?

Mr. LYNN. We don't have a surplus in the Pentagon budget, Mr. Chairman. We spend every dollar that you give us, and we try to spend it responsibly.

Mr. HORN. How much money did you have at the end of fiscal year 1998, that you could reprogram?

Mr. LYNN. I don't have that number in my head. I could provide it for the record.

Mr. HORN. Without objection, it will be provided for the record. Was it $20 billion? Was it $50 billion reprogrammable money?

Mr. LYNN. Oh, no. It would be nowhere near that. To give you an order or magnitude, the omnibus reprogramming which is where we pull together all of that kind of effort where we try and take account of the things that have changed. Some things change in which we either need more money and other things change that we need less money.

The omnibus reprogramming last year was about $1.5 billion, I believe it was. It would be about a half of a percent of the Department's overall budget was reprogramed. That's both a positive and a negative. In other words, in some cases, an acquisition program may miss a test or something and, therefore, resources would not be able to be spent on that program. In other cases, say in a depot, we do more depot maintenance than we anticipated, so we would shift resources from one area to another. But the magnitude would be in that area.

Mr. HORN. So it would be $1 to $2 billion roughly.

Mr. LYNN. That is the normal reprogramming that the Department proposes over the course of the year. Congress actually limits our transfer authority. The limit in the transfer authority this year is $1.6 billion. Last year, I think it was a little bit over $2 billion.

Mr. HORN. I forgot to look at the language, but I looked at it years ago. Generally, you get the sign off of the Chair and the ranking member of your Appropriations and Authorizations Committee. Is that how that currently works?

Mr. LYNN. That's correct, Mr. Chairman. All four of the oversight committees need to approve a reprogramming and they need to approve both the source, that is where the money is coming from, and where the money is going to.

Mr. HORN. Now, we have had Clinger-Cohen in law for about 2 years, right? I don't know the exact date.

Mr. LYNN. I think he has been Secretary for 2 years, so a little bit longer than that.

Mr. DODARO. It has been 3 years.

Mr. HORN. What have we learned from the use of Clinger-Cohen in terms of liberalization of acquisition, and has that been reflected in your financial systems, and what has been the difference between what you did and had prior to Clinger-Cohen that you have now?

We are going to hold a hearing on seeing what agencies are taking advantage of this legislation and liberalized purchasing, and I am just curious about any feelings in the financial management community in relation to that acquisition law.

Mr. LYNN. I'm not sure where you are going with that, Mr. Chairman.

Mr. HORN. I'm going for an answer, hopefully.

Mr. LYNN. I guess I don't have enough of a question.

Mr. HORN. Let's try it out on GAO and the Inspector General. Have you done anything to see how that is being administered?

Mr. DODARO. From our standpoint, we have been focussing more on the aspects of the law to reform the information technology infrastructure, putting CIOs in place with the requisite authority, using disciplined investment processes, and good cost-benefit analysis. There were, as you point out, some provisions to allow for piloting in the information technology arena some advanced acquisition reforms. To my knowledge, there has not been very many pilots exercised. I would have to go back and check on that.

Mr. HORN. It's been in effect 3 years. Is there any plan by the General Accounting Office to take a look at it and see how it is being administered?

Mr. DODARO. Yes, there is, because it is up for reauthorization in 2001. We are targeting for that, and we plan to move more resouces into that as soon as we emerge from this Y2K computer challenge.

Mr. HORN. So that would be early in 2000 you would start?

Mr. DODARO. Start taking an indepth look at all aspects of the legislation.

Mr. HORN. How about the Inspector General's office? Any thoughts, since that is a major purchaser for the Federal Government?

Mr. LIEBERMAN. Mr. Chairman, first of all, we are largely in the same boat the GAO is, that is, we are so involved in the Y2K conversion that we have had to defer a lot of potentially very important audits of DOD's investment processes for information technology and also of our security systems.

There are many different systems involved in the financial management area. There are roughly 200 systems that are directly pertinent to preparing financial statements alone. Many of those are development efforts and others are modification efforts.

I would say that the application of the principles of the Clinger-Cohen Act has been very uneven. We could probably find examples on either end of the spectrum. Some programs would be considered models in terms of good application of principles like modular development, good oversight, good involvement by the Chief Information Officer, et cetera. And on the other hand, I'm sure that we could find lots of examples where the feedback is not so positive.

We need to do a lot more auditing across the spectrum of IT investments in Defense, which spends $15 billion a year buying and modifying systems. As Mr. Mancuso's testimony indicated, for just this population of 200 financial management related systems, we don't really have the kind of management control and oversight of the whole process that Clinger-Cohen envisions. So there is considerable extra work to do.

Mr. HORN. One of the concerns that Members of Congress will have in various committees in both bodies will be the degree to which Clinger-Cohen has reflected some of the purchases at least in small business or in minority businesses, because as some of you will remember, we had quite a battle on the floor in getting that legislation through two chambers. It's just one of the things that

we will be asking about, and we might as well build it into the study.

Ten minutes to my colleague, Mr. Turner of Texas, the ranking member.

Mr. TURNER. I want to talk a little bit with you about the problem of overspending and budget authority. It's mentioned on page 18 of the GAO testimony today. Just for clarification on my part, we were talking a minute ago about reprogramming and this $1.6 billion in transfer authority. Are we talking about the same thing? In other words, the Department has the authority to transfer this year $1.6 billion, but is that what we are talking about that is approved, or is that a separate matter?

Mr. DODARO. It's a separate matter.

Mr. TURNER. Explain that to me so that I will have an understanding. It might help me with the next series of questions.

Mr. LYNN. The reprogramming involves resources that were originally appropriated by Congress for one purpose. That purpose can no longer be accomplished so the Department returns to Congress through its four oversight committees and proposes a different purpose for that funding. That's the process that I was discussing with Chairman Horn. The limit on that transfer authority, which is the reprogramming, is this year $1.6 billion which is somewhat less than it was the prior year. But it's generally in that $2 billion neighborhood.

Mr. TURNER. Those are separate things. You can transfer $1.6 billion within your budget?

Mr. LYNN. That's right.

Mr. TURNER. That's not subject to any congressional approval?

Mr. LYNN. It is subject to approval by the four oversight committees, the House and Senate Armed Services Committee and the Defense subcommittees of the two Appropriations committees.

Mr. TURNER. So the reprogramming that you do has to fit within the $1.6 billion?

Mr. LYNN. That's correct.

Mr. TURNER. Returning then to the portion on page 18 of the GAO testimony—and I suppose I could direct this to Mr. Mancuso or Mr. Lieberman. I assume that I found the right audit report here, the one that refers to the oversight of the Air Force. Is it in this report that the GAO is referring to the $1.1 billion that were obligations incurred in excess of available budget resources as of September 30, 1998?

Mr. LIEBERMAN. We have issed two reports on the Air Force financial statements, one on the general funds and one in the working capital funds. They are both equally thick so I'm not sure which one you have in hand.

Mr. TURNER. Irrespective of whether I have been looking at the right one or not, let's just look at the GAO testimony. It makes mention of the fact that the Air Force audit agency reported that the Air Force's depot maintenance activity, which is a component of one of the Department's working capital funds, may have incurred obligations of $1.1 billion in excess of available budgetary resources as of September 30, 1998.

I guess what I would like for you to do for me is explain—it says may have occurred, as if maybe it occurred and maybe it didn't—

but that would be an awful lot of excess obligations that were incurred there by the Air Force if they had no budgetary resources to fulfill those obligations. If that's the problem, would that be the kind of thing that the Air Force and the DOD should have come forward with and asked for a transfer or a reprogramming to remedy that problem?

Mr. LIEBERMAN. In a case of this type, whenever you have an apparent overobligation, or overdisbursement for that matter, whether it is a small amount or gigantic one like this, there probably will have to be an Antideficiency Act violation investigation, because it is a criminal offense to overspend.

This is a very structured process. The word "may" is used in there on purpose because the auditors can't normally determine definitively that there has been an overobligation or overdisbursement. We are dealing with records that are flawed. It may well be that after the records are straightened out there is not overspending, but this has to be investigated and it will be investigated. The Department of the Air Force will have the responsibility to conduct an Antideficiency Act violation investigation. If a violation is determined to have occurred, the details have to be reported by the Secretary of Defense to the President and the Congress.

Mr. TURNER. If that had been discovered earlier, then it could have been remedied by a request for reprogramming?

Mr. LIEBERMAN. Yes. They will have to find a way to cover the deficiency either through a supplemental appropriation or using current year budget authority. But for an amount that size, certainly they would break a reprogramming threshold and have to come back for congressional approval.

Mr. TURNER. Give me a little bit of a description so that I can understand. What are we talking about that this $1.1 billion may have been spent for? These are Air Force depot maintenance activities. I am a little bit at a loss as to how we could spend $1 billion more than we have budget authority to do so without anybody noticing it or coming forward or requesting reprogramming or something. It is a lot of money, even though it does say may have. Somebody must think they are on to something here.

Ms. JACOBSON. Mr. Turner, perhaps since I put it in the testimony I can explain what the background of this particular transaction is. The Air Force does not have a budgetary system comparable to some of the other services—this depot maintenance facility does not have a budgetary system comparable to some of the other systems in DOD. What they were doing was using an estimate of what their—the budget authority and maintenance account really stems from how much they believe they are going to get in orders and from the service itself.

So the service orders goods and services from the depot to provide depot maintenance, and then the depot uses the money as their budget authority to pay for their people and their inventories to do the actual activity that they are there to perform. These are supposed to be working capital—they are working capital funds. They are supposed to be run like business operations.

Basically, they are supposed to be on a break-even basis. Money comes from the services to pay for the activity as if it were a business activity. They can spend as much as they are going to get

from the services. And in this case, what they were doing is estimating what they thought at the beginning of the year they were going to get from the service, from the Air Force, and using that as their budget authority; and, in fact, they did not get that much activity in that depot. So they ended up obligating more than they actually got in orders and activity from the Air Force.

Mr. TURNER. So this problem occurred at one particular depot location?

Ms. JACOBSON. I believe there were a couple of incidences in Air Force, but I would have to go back and check the Air Force report.

Mr. HORN. Would the gentleman yield for 10 seconds. I'm curious, was this at McClellan Air Force Base?

Ms. JACOBSON. I don't know specifically.

Mr. HORN. How many people were involved? I hear you saying something back there but I can't quite——

Mr. WARREN. There are five Air Force maintenance depots in the working capital funds, so it could have been an accumulation among those five. Two are in the process of closure——

Mr. HORN. Just let the reporter know name and title and so forth.

Mr. WARREN. Dave Warren, Director of Defense Management issues for GAO.

Mr. HORN. I was just curious because those were authorized, or rather recommended by the Hoover Commission. This would be a way that government could do business. And presumably what you took out, as you say, Ms. Jacobson, you get other services or your own service to pay for whatever those maintenance and repairs are. Mr. Turner certainly raised a very pertinent question as to overoptimistic budgeting.

Ms. JACOBSON. In terms of reprogramming, generally, again, these organizations are supposed to recover their cost through their rates. So we would have expected that they would have to raise rates either now or in the future to recover any overexpenditure.

Mr. HORN. It isn't limited to the Air Force in terms of uses. It is other services that can use it. Right?

Ms. JACOBSON. That's correct.

Mr. HORN. Go ahead.

Mr. TURNER. Give me a feel for—we are talking about $1.1 billion in excess obligations. What is the total picture in terms of the total expenses related to depot? We are talking about $1.1 billion out of $5 billion or how big of a problem are we looking at here?

Ms. JACOBSON. My associate behind me is saying that it's about $5 billion for the depots, for the Air Force depot.

Mr. TURNER. Do we attribute this kind of problem to just total incompetence on somebody's part? It seems like a serious breakdown to say that $1 billion out of a roughly $5 billion operation was overobligated. That's a little bit of a shocking number.

I ask the size of it because we have been cautioned here a minute ago not to be too struck by these billion dollar figures because it may be one half of 1 percent of something. Obviously that one wasn't. It seems to me a very serious problem. I see my time has expired, Mr. Chairman, and I will defer back.

Mr. HORN. If you would like to finish up——

Mr. DODARO. If I might, Mr. Chairman, to just add just one broad point to this whole discussion is that prior to fiscal year 1998, the agencies prepared budgetary statements on how well they complied with fund control procedures and provided that information to the Treasury Department and OMB. That information was not audited.

Beginning with fiscal year 1998, the statement of budgetary resources, how much budget authority agencies were given and how much had been obligated and how much remains unobligated, prior year balances, carry overs, et cetera, is now subject to these annual audit requirements to ensure that there is budgetary integrity in the system; and, indeed, that agencies are complying with the limits established by the Congress.

So we are hopeful, and that's one of the reasons why annual requirements are important, that this new requirement in place now will lead to more attention being given to these matters during the year by agencies to make sure that their fund control procedures that are in place are operating effectively and do provide them the internal control necessary to make sure that they either did not overobligate, or have obligations that could be deobligated and used for other purposes.

That's when some of these investigations take place and people go back and scrub these accounts. They find that they have obligations on the books here that they didn't use, so they deobligate that money to cover these overobligations and that is why there is "may" in many of these cases until those thorough investigations are done. That tells us from an audit standpoint that there needs to be more rigor in making sure that the fund control processes operate as intended.

Mr. TOYE. Mr. Turner, if I may, all violations have a negative number, but not necessarily all negative numbers are a violation or are the result of a violation. Let me give you some examples.

Recently in the Navy, preliminary indications were that potentially a number of Navy accounts, over 20, about 29, may have incurred a violation. DOD investigates, as the IG indicated, all of those negative numbers. In those instances in which we have completed those investigations—I should say the Navy has completed the investigations—on over 20 of those 29 accounts, none of those were a violation.

Regarding the incidence of the Air Force negative numbers, DOD will also take a look at that. However, the fact that it is a negative number does not by itself mean that it is a violation. That's why the auditors tend to use the words "may have been" because it may be, as indicated, an accounting error.

It may be other valid reasons that something different than a violation or an overobligation, even though that's what it appears to be at first. We do followup on all of these negative numbers and we do investigate them and we do find that a number of them are simply not overobligations, but we cannot—and we do not—ignore them when the negative numbers appear.

Mr. HORN. One last question and then it's Mrs. Biggert's turn. I just want to get the record clear.

When you find this series of negatives for one reason or another, can you balance those off with other funds in the DOD and the various services where you would pick up a surplus to balance them?

Mr. TOYE. If we have a violation, then the Department needs to correct that violation. They need to fund it. It depends upon the level at which the violation occurs. For example, if it's below the appropriation level, if it's at a particular command—let's pick on the Army since we haven't talked about them yet—if it's at an Army Command but at the Army appropriation level, and there is sufficient funds to fund that negative number, we can do it within the appropriation. If it's at the appropriation level, then we would have to come back to the Congress. But we always report it.

Mr. HORN. Ten minutes to the gentlewoman from Illinois, Vice Chairman Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. I just have one question and that is to start with Mr. Dodaro. You mentioned that the Department has underestimated the future cost of environmental cleanup in the disposal of weapons systems, and then for unexploded ordnance—I guess that's how you pronounce it—from the training ranges. How poorly has this been done? And I guess my question is, how does that fit into the whole scheme of the financial management?

Mr. DODARO. Basically, those figures that the Department has, it's not how poorly the case is. They just have not made estimates for those major classes of weapons systems disposals. We have been undertaking discussions with them. This is in the category of accounting standards that have been adopted but need to be implemented by the Department.

Those amounts are material essentially to the consolidated financial statements of the U.S. Government along with the environmental disposal liabilities estimated by the Department of Energy for cleanup and nuclear weapons complex. That was the one area, looking across the government on the consolidated financial statements, that we knew was understated.

In many other areas, we didn't know if the right number was there. It couldn't be substantiated with this area, because those estimates are not yet being made, that we reached that conclusion that we did. So the Department is in the process now of adopting that standard and then methodologies need to be developed to have a sound basis for making those estimates.

We have provided the Department with some information based on our research of how that could be done as a starting point, a foundation, but they need to implement it.

Mrs. BIGGERT. Mr. Secretary.

Mr. LYNN. Mrs. Biggert, we are doing exactly what Mr. Dodaro said. This goes back, I think, to my comments of my original testimony where I said we are making the shift from a system where we were essentially a budgetary-based system to now we are doing an accrual-based system.

Under a budgetary-based system, your environmental liabilities wouldn't be on the books until you budgeted for them. On the accrual-based system that we are moving to, you would anticipate those liabilities and include them on the financial statement. That is exactly the shift that we are making now.

Mr. Dodaro is exactly right. We are in a discussion over what standards ought to be applied with the FASAB and the other participants in that, and then we are looking at methodologies to try and come up with an acceptable means of estimating those liabilities. I think that we are actually making some progress in that area.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. HORN. We thank you. Let me just ask a few general questions here and let everybody get into it. I have a lot of confidence in Secretary Cohen and Deputy Secretary Hamre.

Mr. Lynn, you are the Under Secretary. What is it that you need to solve those problems, and are you getting the support from the Secretary and the Deputy Secretary? Could you outline for us the strategy of how the next time we meet we will have a lot of these things cleaned up; and, if we are going to have that situation, what are you going to have to ask for?

Mr. LYNN. Mr. Chairman, I think that we have asked for it. It starts at the top, as you said. We have the support of Mr. Cohen, who came to the Department with some experience in this area. You referenced the act. He sponsored the Clinger-Cohen Act and his participation in your corresponding body in the Senate in which he was a Member. Deputy Secretary Hamre, having had this job, fully understands the problems and is committed to the solutions.

What specifically are we doing? That I tried to indicate in my opening testimony. The biggest thing we need to do—and it was a point Mr. Mancuso stressed—is we need to improve the systems. We have a plan in place that is going to update all of the financial accounting systems and neck them down to 32. That should be complete by 2002. We are two-thirds done; we are on track to complete the rest. That will put us in a very good position with regard to the 20 percent of the data that is on the financial statement that comes from those systems directly. The other 80 percent that we have taken the next step just this past fall, which is to do a financial management improvement plan.

The major comment that we got from the auditors is we need to take further steps on the feeder systems. They are absolutely right. That is, indeed, the next step. That is where we are going. I have been holding meetings on a monthly basis with all of the departments which are the action agents in this regard. We have tapped, in general, the financial manager of each department to try and put in place a system of upgrades to the feeder systems, the logistics, the acquisition, the personnel, the medical systems, all of the various systems that feed data into the finance and accounting. We are taking those steps as we speak.

As I said, it involves quite a major effort involving all components in the Department. Finally, we have been meeting not quite on a monthly basis, but with the audit agencies as well as OMB to develop these interim strategies that I mentioned earlier.

I think the most helpful step and really the corner stone of that effort was the auditors identifying what they the called "show stoppers." What are the five or six items that are really causing us—what are the five or six deficiencies in the financial statement that we really need to address, valuation of real and personal property, the connection of the inventory systems and so on.

Mrs. Biggert just left, but the liabilities issue that she mentioned. We are attacking each one of those. We are trying to develop a strategy that will get us better data in advance of the final effort which is the improvements in the systems.

Mr. HORN. Does the General Accounting Office have anything to add to that outline of a strategy to solve some of these problems?

Mr. DODARO. As I indicated in my statement, both oral and written, I'm very encouraged. The Secretary had put out a memorandum, which is the first time that there is a written document urging that this be given priority across the Department.

And everything that Mr. Lynn outlined is correct. We are engaging in short-term activities. The big question mark in my mind is that financial management reform is a Department-wide issue. And Mr. Lynn is a very important player there, but he needs the cooperation of both the military and the civilian leadership across the Department.

I was also encouraged that the Secretary adopted the financial management reform under the defense reform initiative which means that the senior management of the agency will follow it and track it and develop it. That to me will be the telling of the tale as to whether or not the reforms are adequately implemented a year from now; as to whether the financial management reform is as vigorously pursued as the year 2000 computing challenge problem; and whether the very top people across the Department are helping Mr. Lynn and his colleagues achieve change.

That, only time will tell. But unless that happens, a lot of these plans will not bring about the real improvements that are needed. But the foundation is being laid. This is a question of follow-through and execution on the plans. And Defense, like a lot of agencies, have had many good plans that just stay on the shelf and never get implemented. This is a case where we are watching that very closely, and that will be the pivotal element in this whole exercise.

Mr. HORN. Mr. Mancuso, how does the Inspector General feel? Is that strategy outlined by Mr. Lynn acceptable to the Inspector General's office?

Mr. MANCUSO. Yes, it is. And I would add that the Secretary, the Deputy Secretary, and Mr. Lynn have been supportive of our efforts. In the past few years—and I know your committee has heard this story—our budget had been planned to decrease at a dramatic rate. We were up around 1,650 people in 1994; we're at about 1,250 people now, and we were scheduled to decrease another 200 people in the next 2 years.

The Department sat down in good faith and discussed this matter with us. We presented our concerns as to why we felt that we could not do our statutory job and the job that the Department deserves and needs in handling such things as high risk areas, et cetera, without some relief.

The Deputy Secretary and the Comptroller negotiated that relief with us. We're now on an even path to maintain approximately our current level of resources, and we believe we will be able to cover the things that absolutely need to be covered. We also have ongoing negotiations with the Comptroller involving the number of entities for which annual statements will be required.

And we feel that with some possible relief in that area, we may be able to shift some resources toward, again, more concentration on the underlying problems. We also have, I think, a healthy relationship with the Department in that we've been asked to participate in well over 100 process-action teams and improvement task forces in the Department.

So the IG has become an active player in identifying some of the problems and seeking solutions at an early stage. And as Mr. Dodaro said, we view as very positive the fact that the Department is willing to consider using the Y2K methodology in addressing some of the more serious financial management challenges that we have.

So in sum, I would say that we are quite pleased and we believe that we have general agreement with the Department as far as how efforts need to be focused in addressing such important challenges as financial management.

Mr. HORN. We could stop here, but I just want to get them on the record. Computer system security, the General Accounting Office, and the Inspector General have reported on the vulnerabilities that exist in the Department of Defense's computer systems. The Inspector General, in its written testimony, stated that the defense financial systems that processed nearly $300 billion in disbursements annually are clearly at risk.

Could you expand on that area. How much of a problem is this? Usually, we've read headlines somewhere during the year that some 18-year-old has cracked into a defense system. I mean, can we protect most of those or where are we on that?

Mr. MANCUSO. Again, what I would say is that, as you are well aware, 18-year-olds may attack any system. We had a case just recently where there was an attack on a DOD system and the same individual had actually had a hacker attack on a nuclear facility in India, so that there's certainly no sacred systems out there.

The Department of Defense presents a very dramatic challenge for a lot of hackers. Our financial systems are of great concern, and the Department is rightfully not placing emphasis solely on security issues. They're looking at whether we are protecting our resources.

The way to do that is through a strong infrastructure protection program; and we're working on that. We're reasonably satisfied—in fact we are satisfied with the efforts of the Defense Information Systems Agency in that regard. We have individuals, trained individuals, that we have placed in DISA to help us develop the mechanisms to identify problems and to react to them. So on that one, yes, we are satisfied with what the Department is doing. We're reasonably assured that the right level of effort and concern is being placed there.

And we're hopefully optimistic, I guess, that the controls that are in place or are being put in place right now will succeed.

Mr. HORN. Any comment from the General Accounting Office?

Mr. DODARO. From our aspect, as you know, we've identified computer security across the Federal Government as a high-risk area. Along with Y2K, back in early 1997. Those were the first two areas we've ever identified governmentwide on our high risk program. The risks are increasing as we become a more interconnected

world, if you will, the increased use of the Internet. The Internet, as many people have said, it's not ready for prime time from a security standpoint.

But to give you some indication, in 1995, we issued a report where the Defense Department estimated that there were approximately 250,000 hacker attacks on the Department during that particular year and it estimated about 60 percent or so have been successful. This is a growing problem.

I agree with Mr. Mancuso that the Department has given this elevated attention over the past few years, thanks to Deputy Secretary Hamre. I also know Mr. Lynn has been involved, as well the Defense Information Agency. They do have an information assurance plan in place. It's being staffed now. But, again, it's not yet implemented; and it needs to be implemented.

And this is another example of a Department-wide problem that needs department-wide attention and execution. And we're going to continue to followup and evaluate those computer controls as part of the annual audit. But the Department of Defense, like some other Department's are really an attractive target for people; and there's growing capacity of people developing information warfare capabilities. And this is a very serious issue.

I was pleased to see after we designated this a high-risk area the President came out with a decision directive, Presidential Decision Directive 63, that talked about trying to secure critical information infrastructures across the country, not just the Federal Government, but on electric power systems, telecommunication systems, and transportation systems. It's a very important issue. And I would urge this committee to really continue to keep an eye on that.

Mr. HORN. Mr. Lynn, do you want to add something to that? You heard the 1995 number. What has it been in 1998, 1999 in terms of hacker attacks?

Mr. LYNN. I'm afraid that's outside my knowledge at this point. I would be happy to provide it.

Mr. HORN. OK. For the record.

Mr. LYNN. For the record.

Mr. HORN. Without objection, it will be in the record.

This is really a national security thing, obviously. Is the National Security Agency involved to help get at the hacking problem?

Mr. LYNN. Yes, they are. They are—there are a couple of agencies in the Department. Mr. Dodaro mentioned DISA, the Defense Information Assistance Agency. We also have an information assurance team at the NSA, and they do a great deal of work both in terms of monitoring our systems as well as looking to the future and trying to anticipate future threats and develop hardware and software and techniques for doing that for dealing with that.

Mr. HORN. There's no problem within NSA's help, no problem in having their help?

Mr. LYNN. No, they're a full member of the team.

Mr. HORN. Yes, OK. Because Secretary Weinberger, I think, was the first Defense Secretary they realized they report to him; and when they were going around him, there was little discussion with the then commanding general. I'm glad to hear they are helping.

Mr. DODARO. Mr. Chairman, I might add that the National Security Council has been given lead responsibility under this Presidential Decision Directive to get involved. They're asking for plans from each of the Federal agencies. They're working with OMB. We've made a series of recommendations to make sure that it is coordinated and there's adequate follow through. So, again, I'm pleased to see that they are involved on a broad basis.

And they're also trying, as relates to an earlier question by Congressman Ose, to develop training to make sure there are adequately trained people to be security administrators in the area. This is another area where security is always taking a back seat to making the system more user friendly, more easily accessed; and security now needs to be elevated to be a competing priority.

Mr. HORN. That's fine. Nothing else to add, Mr. Lynn, to this? You're happy with the security?

Mr. LYNN. Well, I don't want to say happy or satisfied. We're well aware of our attractiveness as a target. With my specific responsibilities for the defense finance and accounting service, we are taking it very seriously. We have a team down in Florida that focuses exclusively on that, as I think Mr. Mancuso's testimony indicated. We have taken the vast majority of the IG recommendations with regard to that. And it's, I think, a constant effort to try and stay ahead of the hackers and other people who would wish us ill.

Mr. HORN. OK. The General Accounting Office has testified that in raising its capitalization threshold from $5,000 to $100,000. The Department of Defense has effectively removed billions of dollars in assets from accounting controls. Do you still feel strongly on that?

Mr. DODARO. Well, part of——

Mr. HORN. Can you elaborate?

Mr. DODARO. Well, that issue, the capitalization threshold issue needs to be reexamined. Mr. Lynn and myself and our organizations have had an ongoing dialog about that, as well as with the contractors that DOD has hired to look at the real property and personal property area. I know Mr. Lynn is going to have them take a look at the capitalization threshold. I'm very encouraged that they're reconsidering that now, and hopefully we can come to an acceptable outcome that we can all feel is an agreeable solution to this issue.

It's important not only from asset control and accountability but also in coming up with costs associated with the useful life of the assets and spreading those costs over a period of time, so that when cost comparisons are made between DOD activities and commercial activities where they have much lower capitalization thresholds and their costs are spread over a period of time that there's a comparability and also for charging prices under DOD's working capital funds so that there's adequate consideration of what the appropriate costs would be over time, depending on the assets.

Mr. HORN. How would you define the capitalization aspect at $100,000? I mean, is there a definition there of what is in and what is out in terms of capitalization or potential capitalization?

Mr. DODARO. The Department has a definition that's fairly generic, although there are some nuances. I think the likely outcome

will be more capitalization thresholds targeted to different types of assets, rather than a more of a generic approach.

Mr. HORN. How are we defining this, Mr. Lynn?

Mr. LYNN. As Mr. Dodaro indicated where this is an issue that we're actively working, as we speak, I guess I would not agree with your characterization. The threshold takes assets off the statement. That is actually not true. It's a question of timing. Assets that are above the threshold are put on the statement and depreciated over time. Assets that are below the threshold are also on the statement. They're just expensed all in the year that they're purchased. But either way, they end up on the statement. The difference is, as Mr. Dodaro indicated, the accounting treatment. Do you want to treat this as a capital asset which you depreciate?

We think at this point $100,000 is the right level. We do not want to depreciate, say, a fire hydrant. That isn't valuable. Actually, it takes quite a bit of work to depreciate these things, and there's no value to us in depreciating things that low.

Having said that, we have asked, as Mr. Dodaro indicated, two private contractors to come and, based on commercial standards, to come in and recommend to us where our thresholds ought to be. And we plan to evaluate those recommendations as we get them later in the summer and work with GAO.

The other point I would make, though, is DOD's threshold at $100,000 actually puts it in the middle in terms of government agencies. There are several agencies that are higher, or at $100,000, that have received clean opinions, and GAO has approved those clean opinions. Those are agencies that are considerably smaller than that that have many fewer assets and you would think have a lower threshold than DOD, but it's actually equal to or greater.

So there's a prima facie case there that we're at least at a reasonable level if other agencies are able to get a clean opinion at that level.

Mr. HORN. Does the Inspector General have a dog in this hunt?

Mr. MANCUSO. I think I'm going to defer to Mr. Lieberman on this one.

Mr. LIEBERMAN. No, we do not feel strongly about what the threshold should be. As these gentlemen and lady know, we're most concerned with the Department's ability to accurately account for these items, no matter what the threshold ends up being. So I think we will just stay on the sidelines and then try to enforce the rule, whatever it turns out to be.

Mr. DODARO. As Mr. Lynn indicated, this is a governmentwide issue, and we're exploring it on a governmentwide basis to make sure there's consistency across the agencies.

Mr. HORN. You've got a study under way?

Mr. DODARO. Yes, we're going to start this spring.

Mr. HORN. Has that been requested by a particular committee?

Mr. DODARO. No.

Mr. HORN. We will request it then.

Mr. DODARO. I can always count on this committee, Mr. Chairman, for requests.

Mr. HORN. I held this partnership in assets of property last week. We might as well see what's being either amortized or expensed, as the case may be.

Mr. DODARO. Request accepted.

Mr. HORN. Although I have great sympathy with Mr. Lynn, why are we fiddling around with a fire plug at $5,000?

Mr. DODARO. I don't think that's in my statement, Mr. Chairman. We're not talking about fire plugs.

Mr. HORN. OK. That's gone to the dogs, too, I think.

Are expense assets tracked as to where they are or is it what the condition they're in or what are we talking about when you expense something?

Mr. DODARO. Well, that's part of the issue that we want to have examined. It's one thing to have an expense, but there needs to be control from an internal control standpoint that the asset is safeguarded, it's protected from theft and, that the Department knows the location, the condition that they could use it properly.

So that's one of the other reasons why, as Mr. Lieberman just articulated, beyond the capitalization level, there's a stewardship responsibility for any use of the taxpayer money to make sure that there's accurate tracking of that and to be put in place. So the asset accountability and stewardship responsibilities are throughout the use of the money and the tracking of those assets. That needs to be dealt with.

There are problems associated with tracking, which are included in my statement and the Department's and the Inspector General's reports about inaccuracies of information of assets under $100,000 and how those are properly accounted for.

Mr. HORN. So, between the three forces here that relate to Defense in some way or the other, you think this will be worked out on some consensus?

Mr. DODARO. That is our goal, Mr. Chairman. I must admit we've had some spirited discussions on this particular issue. I think—part of the problem is that there's not accurate information to do analysis in the beginning, to find out how many of the Department assets—assuming certain threshold levels—how much of the assets are really removed and expensed on an annual basis.

There's also the comparability issue from an IRS standpoint. The IRS is much more judicious about a private enterprise's assets that have a useful life over a year, and there are other standards that need to be looked through. So I'm always optimistic that we're going to be able to work this out. I hope we can.

But if we can't, we will have to acknowledge our differences and outline what those are and make the judgments that we're all paid to make.

Mr. HORN. Any comments, Mr. Lynn?

Mr. LYNN. I certainly hope we will be able work it out. That was the purpose of the hiring—or asking the two outside CPA firms to make a recommendation was to try and get a common basis from which to proceed. It is a difficult issue, though. The Federal Accounting Standards Board did look at the idea of setting a governmentwide standard and found it too complex and too difficult and chose not to.

Mr. HORN. Have you had that report from the accounting firms yet?

Mr. LYNN. No, they're just reviewing the data bases as we speak; and as Mr. Dodaro indicated, you have to make first a judgment about the accuracy of the data bases and what the value of below $100,000 or below any threshold is, vis-a-vis the statement, before you can make a recommendation. So they're in that part of the process right now.

Mr. HORN. I assume you're using the Y2K mess as a way to take a look at a lot of systems you either don't need or you need in better hardware and software?

Mr. LYNN. Yes, we are.

Mr. HORN. This is an opportunity to throw a few overboard.

Mr. TOYE. Mr. Chairman, before we leave the capitalization issue, I think it's important to understand that within DOD we make a distinction between accounting and accountability. And irrespective of what the capitalization threshold is, that does not mean that anything below that threshold does not have accountability controls, that is, we maintain controls, we know where the item is, and what the condition is.

All of those items that Mr. Dodaro mentioned that we should do for those items below the capitalization threshold, we do do, so the accounting threshold does not automatically eliminate accountability for those items that are below that threshold. And I think that point is important also to consider.

Mr. HORN. Well, that's certainly true on a base in terms of inventory. And it sort of mellows out, I think, at a few other levels. Has anybody lost any ships this year or missile launchers that we can't find?

Mr. LYNN. No, Mr. Chairman, we have not lost any ships or any missile launchers.

Mr. HORN. OK. That's good to know.

On that optimistic view, we will close the hearing; and I will thank the staff for its work. I thank the witnesses for their work. J. Russell George is the staff director, chief counsel for the Government Management, Information, and Technology Subcommittee. The director of communications is way in the second row from the last wall there, Bonnie Heald, and professional staff member; and then on my left and your right, Larry Malenich, the detailee from the General Accounting Office. That's why we get thoroughly into these things. Mason Alinger in the corner over there is our faithful clerk that makes sure that things are set up around here; and Richard Lucas—is Richard around today? Richard isn't. He is our intern. Faith Weiss, counsel to the minority and Earley Green, staff assistant. And our court reporters are Cindy Sebo and Randy Sandefer.

So with that, we thank you all for coming over. And we adjourn this session.

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

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