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FINANCIAL AUDIT

Immediate Actions Needed to
Improve Army Financial
Operations and Controls

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147327



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to discuss the results of our first comprehensive review of the financial operations of the Department of the Army. This discussion is particularly timely today. The Army, along with the rest of the national defense establishment, is planning for major downsizing and at the same time seeking to achieve needed readiness goals. Effective and efficient management of all available resources through financial management systems and operations is critical to achieving these goals.

Our comprehensive review included an audit of the Army's fiscal year 1991 financial statements conducted under the Chief Financial Officers (CFO) Act of 1990 (Public Law 101-576). In our separate report on this audit which is available here today, we stated that significant uncertainty exists regarding the statements' overall completeness and accuracy. We also reported that internal controls could not be relied upon to safeguard assets and assure accurate financial reporting or compliance with certain laws and regulations. These results were not entirely unexpected because of known problems acknowledged by the Army at the outset of our audit. I am encouraged by the Army's acknowledgment of its problems and its commitment to take action to address these problems.

Our full report on the results of our comprehensive review is also available here today. Consequently, I will limit my remarks to illustrating a few of the problems we found, proposed corrective actions by the Department of Defense (DOD), and our views on areas needing additional attention.

In discussing our audit results, it is important to recognize that the Army carried out unprecedented deployment and combat activities under Operations Desert Storm and Desert Shield during fiscal year 1991. About one-third of Army's active forces were directly involved, and most other Army activities were at least indirectly affected by the deployment. Despite this activity, the Army continued to cooperate with us on our audit. In our judgment, the deployment did not affect the audit's overall outcome because many of the problems we noted were long-standing and systemic in nature, but it is likely that the severity of the problems noted were increased by the deployment.

Our findings are not unusual for a first time audit. Unlike most of the private sector, the government has not until recently required its agencies to produce financial statements. Therefore, the kinds of financial discipline, procedures, training, and systems needed to produce such statements have not existed in government. To the credit of this committee and others, the CFO Act now provides a framework for addressing many of the government's long-standing financial management problems. As federal agencies cope with weaknesses disclosed by audits mandated by the CFO Act, overall improvement in the financial management activities, as well as savings and benefits from reduced costs and efficiency improvements, can be anticipated. We believe the

weaknesses can be overcome, but only if there is enough financial support to strengthen the systems and processes, interim measures to realize benefits quickly, and, most importantly, strong, sustained commitment from top leadership.

SOUND FINANCIAL INFORMATION ESPECIALLY CRITICAL IN TODAY'S ENVIRONMENT

The Department of the Army, along with the rest of the national defense establishment, is at a major turning point after the nation's greatest peacetime defense buildup. With the collapse of the Soviet Union, budgets are being reduced and managers are striving to downsize forces with the least loss of readiness and to make the best use of increasingly limited resources.

With a reported \$346 billion in assets and fiscal year 1991 budget authority of about \$92 billion, the Army represents one of the largest management challenges for the federal government. The Army's projected downsizing plans for fiscal years 1990 through 1997 call for reducing its 1990 workforce of an estimated 1.9 million by about 469,000. Efforts to reduce costs have also led to DOD organizational and administrative changes--such as the consolidation of the military services' accounting functions under the Defense Finance and Accounting Service, the Department's Corporate Information Management initiative, and the establishment of the Defense Business Operations Fund. Our review had to consider these initiatives because of their significant affect on Army financial systems and operations now and their possible impact in the future.

MAJOR FINDINGS ON ARMY FINANCIAL AND ACCOUNTING OPERATIONS

Our audit work noted significant problems in almost all areas of the Army's financial operations. Because the Army does not have an integrated accounting system, preparing financial statements required assembling and processing data from a variety of accounting, logistics, and property systems. As a result of the systems problems and inaccuracies in data generated by the systems, the Defense Finance and Accounting Service had to initiate about \$250 billion in adjustments to Army provided data before it could prepare Army's financial statements. Although it did not recognize the full extent of the problems, the Army was aware of many of the weaknesses we found during our audit. Before the audit was completed, the Secretary of the Army formed a high level special action group to deal with issues surfaced through our work.

To address these problems, the Army and DOD must jointly undertake better interim and long term actions. Before dealing specifically with these actions, I would like to highlight findings in just one area--inventories--in which corrective actions can produce

immediate and long-term benefits in administrative cost savings and more efficient use of available resources.

Army Inventories Are the Most Serious Area of Concern

The Army's financial statements reported a \$17 billion inventory of spare parts and supplies as of September 30, 1991. However, the Army's inventory records and accounts did not accurately record either the quantities or the values of that inventory. The Army has acknowledged that the accuracy of its inventory records has been diminished by its failure to perform physical inventories required by Army policy. Also, inventory records did not report reliable information because other accounting policies were not followed or were inadequate. Examples include the following.

- About 35 percent of the recorded quantities were inaccurate by 10 percent or more for the \$12.5 billion inventory controlled by Army depots.
- Controls over the \$7.4 billion in government material and equipment furnished to contractors were inadequate.
- Over \$18.4 billion of ammunition inventory held in central storage areas at installations was not recorded in accounting records that support financial statement values. There were no accounting or logistics records for about \$0.8 billion of ammunition inventories either in transit or in production,
- About \$0.9 billion in inventories held by combat and support divisions were not recorded in accounting records that support financial statement values.
- The Army has unrequired inventories of \$2 billion, or 12 percent of its reported inventory value, and additional inventory originally valued at about \$2 billion with an expected salvage value of \$50 million is in the process of being disposed of.
- Custodial records were inaccurate for the \$2.3 billion in inventories stored at installations.
- Obvious errors in inventory reports and records, such as negative inventory account balances, were not being investigated.
- Large amounts of inventories waiting for repair and stored at depots were not always effectively secured to prevent theft or loss nor adequately protected to prevent weather damage.

Unfortunately, DOD is not persuaded that there is a serious problem with respect to its \$12.5 billion Army depot inventory. DOD in responding to our report cited that the Army's accuracy rate was

93.5 percent. We believe this cited rate is unreliable and misleading because

- Army concentrates on controlled and sensitive inventory items which comprise only about 5 percent of the inventories;
- Items included in Army's counts are not statistically selected;
- According to DOD, Army completed only 35 percent of its required counts, and
- the same items could be counted more than once.

Our conclusion that wholesale depot records are inaccurate is based on an Army-wide statistical sample of 278 types of inventory items with a total reported value of \$2.6 billion. We found overages of \$736 million, and underages of \$157 million, for a total misstatement of \$893 million, or 34 percent of the sample universe. In part because of the high error rate, we could not statistically project the dollar amount of the error to the total depot inventory. Nonetheless, we were able to statistically project that 35 percent of the records for this inventory differed from amounts on hand by 10 percent or more. Based upon this information, we believe it is clear that inventory accuracy represents a serious problem. Army plans to start taking statistically based inventories. Hopefully, their own experience with these physical inventories and an evaluation of the weaknesses of the present inventory accuracy report will be persuasive to DOD and they will acknowledge and deal with this problem.

Army and DOD must address these serious inventory problems and should do so immediately. Lack of good information on what is on-hand can lead to wasteful over-ordering as the Army supply system strives to be sure that material is available to meet readiness demands. The incidence of unrequired inventories has to be reduced. Many factors contribute to these conditions, but lack of good data is clearly one of the important ones. Unrequired inventories are costly not only because they represent expended taxpayer funds that cannot be recovered when unrequired inventories are disposed of, but also because of the costs to store and maintain the inventories. Unreliable and inaccurate information for inventories also exposes inventories to loss from theft or from diversion to improper use.

OTHER ISSUES

Our audit noted problems in numerous other areas of Army's financial operations and reporting. These are discussed in detail in the report we released today. Some of the more significant of these are in the following areas.

- Military equipment reported at \$151 billion was not valued at actual costs as required by DOD policy.
- Other equipment was not recorded properly; for example, the Corps of Engineers was unable to substantiate the location or values of \$1.3 billion in equipment recorded in its general ledger.
- Financial records for Army's real property valued at \$61 billion were often not adequately supported or maintained.
- Future liabilities for such things as chemical weapons destruction, environmental pollution, and clean-up of hazardous waste sites were not disclosed as required by DOD policy.

Need to Strengthen Internal Control Process

Our review of Army's internal controls and systems disclosed weaknesses not identified by Army's own evaluation under the Federal Managers' Financial Integrity Act of 1982 (FMFIA) (31 U.S.C. 3512). Consequently, we recommended that this evaluation process be strengthened. In addition, based on our evaluation of the overall magnitude of Army's internal control weaknesses and the inaccuracies noted in our financial audit, we disagree with the Army's fiscal year 1991 statement to the Secretary of Defense stating that the Army's internal controls provided reasonable assurance that the objectives of the FMFIA were achieved. We recognize that this represents a matter of judgment and do not question the Army's good faith in reaching a different conclusion. As you know, we have expressed concerns about the effectiveness of the FMFIA process generally. Our experience with this Army audit demonstrates that the required reviews of controls under the CFO Act will serve to strengthen the effectiveness of FMFIA.

ARMY ACTIONS TO ADDRESS FINANCIAL MANAGEMENT PROBLEMS

Now I would like to turn to Army's actions to address financial management problems. As noted earlier, the Army established a special action group in May 1992 to help oversee and coordinate corrective actions for the problems we identified. This group reports to the Assistant Secretary and is composed of representatives from the offices of the (1) Assistant Secretaries for Financial Management; Installations, Logistics, and Environment; Research, Development, and Acquisition; and Civil Works, (2) Military Traffic Management Command, (3) Deputy Chief of Staff for Logistics, (4) Corps of Engineers, (5) major commands, and (6) Defense Finance and Accounting Service. The group is directed by a steering committee composed of senior-level military officers and senior civilian officials. We are encouraged by the proactive approach the Army is taking to overseeing correction of

its financial management deficiencies. Sustained top management commitment and the cooperation of many functional areas within the Army will be required to correct problems identified.

Many of the recommendations in our comprehensive report are directed toward actions that can be facilitated by the special action group. Because the senior-level group reports directly to the Secretary of the Army and includes top officials from the various Army organizations that will be required to carry out the changes needed, it provides a servicewide perspective to individual efforts to implement our recommendations. It is particularly important to bring together the efforts of the various logistics and accounting groups. The special action group also plays an important role by providing information to the Army Secretariat. This should help ensure that the problems are dealt with and necessary actions are accomplished.

DOD FINANCIAL MANAGEMENT INITIATIVES

The DOD initiatives which I mentioned earlier will affect not only DOD's implementation of the CFO Act but also the structure and operations of the Army's financial systems.

Defense Finance and Accounting Service

DOD has made significant changes in its financial organization and operations and is now moving to centralize control of financial operations, including external financial reporting, previously handled individually by the military services. To standardize accounting systems and eliminate duplicate efforts, DOD has begun to consolidate the military services' accounting functions and plans to develop an integrated accounting and financial management system capable of producing auditable consolidated financial statements. On January 20, 1991, DOD established the Defense Finance and Accounting Service to consolidate finance and accounting activities throughout the department. This organization is composed of a headquarters and various finance and accounting centers previously operated by the three military services and the Defense Logistics Agency.

DOD plans to transfer most Army, Navy, and Air Force accounting and finance offices to the Defense Finance and Accounting Service. This transfer would give DFAS virtually all responsibility for operating and maintaining Army accounting and financial systems. However, the Army would retain responsibility for other systems, such as logistics and supply systems currently used for a portion of Army's financial reporting.

Consolidating accounting operations under DFAS represents a significant departure from past DOD practices. We recognize the potential benefits in reduced administrative costs and, eventually, better quality from the accounting function. However, during such

significant transitions, responsibilities and accountabilities must be logically and clearly defined. The interactions between various functions at the Army and the accounting system functions at DOD also require top management attention.

Corporate Information Management

In response to the President's February 1989 address to the Congress calling for improved DOD management, DOD initiated a number of comprehensive, long-term projects in July 1989 to streamline its administrative operations. Initiated in October 1989, the Corporate Information Management (CIM) initiative's objectives include (1) implementing new or improved business methods through the use of modern automated systems and creating more uniform practices for common functions and (2) improving the standardization, quality, and consistency of data from DOD's multiple automated information systems. CIM is intended to eliminate or reduce systems that perform the same functions. We believe the initiative, if properly carried out, can deliver major savings and efficiencies. However, a project of this magnitude will require many years to complete.

Under CIM, DFAS is establishing requirements for standard financial systems and is selecting "migratory systems"--those systems which represent the best of a particular type of system (for example, a civilian payroll system)--to be adopted by all DOD organizations and serve as a baseline system for continuing improvements. By fiscal year 1997, DFAS plans to implement standard migratory systems throughout DOD. Ultimately, DOD plans to have a single integrated financial and accounting system.

According to information DOD officials provided subsequent to our audit work, DOD has selected eight migratory systems and plans to have them implemented between 1993 and 1995. However, DOD has not yet selected migratory systems for the major accounting functions, such as installation level accounting, general accounting for direct appropriations, cost systems for the Defense Business Operations Fund, and property accounting. These systems will account for hundreds of billions of dollars and will be key elements needed to achieve accurate, reliable financial reporting. According to senior Defense Comptroller officials, they plan to select a general accounting system before January 1993 and Defense Business Operations Fund accounting systems by March 1993.

In identifying and developing systems, the CIM methodology requires that business processes be defined and improved. These processes include internal controls and interfaces with programmatic functions and systems. We agree with this concept. Many of the weaknesses we found result from inefficient or ineffective business practices. However, DOD officials told us this process was not followed in selecting the migratory systems. Therefore, unless the weaknesses are corrected, DOD's migratory systems will have the

same problems as the existing systems and thus will continue to generate inaccurate, unreliable data.

We are concerned that DOD and the military services may be relying too heavily on technology to resolve financial problems. In addition, many of the CIM migratory systems will not be implemented for a number of years and other critical systems have yet to be selected. Therefore, DOD and the military services will have to continue to rely on existing systems and reports produced from those systems for decision-making purposes. Therefore, it is extremely important that greater emphasis be placed upon improving the data accuracy and operations of existing systems. We believe substantial improvement in existing systems is possible through (1) closer adherence to established policies and procedures and (2) greater efforts to deal with and correct error conditions.

Defense Business Operations Fund

Another significant project that will significantly affect Army financial management operations is the Defense Business Operations Fund, established in October 1991 to focus management attention on managing the cost of DOD support operations. The Fund charges the Army and other customers (DOD components) prices for support operations the Fund provides so that it can recover the full cost of these goods and services, including administrative and operational expenses. By identifying the Fund's full costs, DOD managers can make better informed supply decisions that are expected to increase operational efficiencies and lower costs. The DBOF concept is good and, properly carried out, can generate very substantive cost savings for the military. The financial system improvements DOD currently has underway under the Corporate Information Management initiative and the Army's effective participation in these initiatives are critical to achieving the Fund's objectives.

In addition to incorporating Army's stock and industrial funds, the Fund consolidates seven other existing industrial and stock funds operated by the military services and DOD. DBOF also incorporates the activities of DFAS, the Defense Industrial Plant Equipment Services, the Defense Commissary Agency, the Defense Reutilization and Marketing Service, and the Defense Technical Information Service. For fiscal year 1993, DOD estimates that the Fund will have sales of goods and services of about \$81 billion.

DOD has developed a plan outlining the tasks to be performed to allow the Fund to achieve its intended objectives. For example, the plan calls for developing most of the Fund's policies and procedures by September 30, 1992. As of June 1992, Defense indicated that it expects to meet those milestone dates. The House of Representatives has also incorporated the key tasks and milestone dates mentioned above in the Defense appropriation bill for Fiscal Year 1993 (H.R. 5006, passed on June 5, 1992).

The Fund's ultimate success depends on accurate, reliable, and integrated cost systems which would provide information for (1) establishing accurate prices to charge customers for goods and services, (2) furnishing key elements of cost information to managers to enable them to better control costs, and (3) generating required information on inventory values and the cost of sales for the preparation and audit of the Fund's financial statements. However, the existing cost accounting systems used by the stock and industrial funds are inadequate to achieve these objectives fully. Further, DOD has not finalized requirements for the migratory cost accounting systems it plans to use to replace existing systems. There is a need to speed action to improve the systems upon which DBOF is dependent. But, while this is going on, every effort must be made to improve its accuracy of information provided by existing systems so that more of the benefits of DBOF can be achieved in the short run.

Improvements in financial management systems and the quality of financial information must begin with concerted efforts to improve data in existing systems. Reliable financial data are needed for management decision-making now, as well as in 2 or 3 years when migratory systems are implemented. Furthermore, unless current weaknesses are corrected, inaccurate data contained in existing systems will be entered into any migratory systems adopted as a result of the CIM initiative, and thus the migratory systems would also be unable to produce reliable information.

SIGNIFICANT IMPROVEMENT ACHIEVABLE
WITHIN EXISTING SYSTEMS AND PROCESSES

Even if present DOD plans can be accomplished within the time frames stated, it will be some years before migratory systems are implemented and later yet before we see new modern systems. We believe that existing accounting systems can operate much more effectively through disciplined adherence to existing policies and procedures and that immediate payoffs are available. The resulting increase in data reliability could help minimize unnecessary purchasing of inventory items and unnecessary inventory losses. Because of the DFAS's expanded responsibility for accounting information, DOD needs to join Army in making disciplined adherence to existing policies and procedures and cleanup of the existing data problems top priorities.

Making needed improvements to financial systems and operations will enhance managers' abilities to make the best use of available resources and contribute to realizing a smaller but still highly capable force by fiscal year 1997. There are no easy choices in this regard because, barring unforeseen events, the reduced threat environment and budget constraints will inevitably result in a smaller Army.

Effective financial management within the Department of the Army will depend in part upon the successful implementation of organizations--like DFAS and DBOF--and programs--like CIM--managed by DOD. However, many issues need to be resolved and accounting systems improvements implemented before the organizations can operate effectively. The consolidation of business activities under DBOF will not focus on the cost of operations or result in greater efficiencies unless proper systems and policies are in place. Consolidating responsibility for accounting systems improvements under CIM can result in substantial cost and efficiency benefits, but important interim actions are needed to ensure success and accelerate achievement of benefits. In addition, DOD needs to ensure that adequately trained personnel and resources are available to attain its objectives.

Many of DOD's proposed solutions to both the Air Force's problems we previously reported and testified on and the Army's problems discussed today are of a long-term nature. While DOD's solutions may eventually improve financial operations and management if properly implemented, the military services' can ill afford to wait for accurate, reliable financial data to make the decisions required today for force reductions and downsizing. We know that resources are tight and declining, but the military services could take many short-term actions, such as we have proposed, to improve financial management now and provide more accurate, reliable financial data for the new systems.

In this regard we are particularly encouraged by the Army's willingness to forthrightly acknowledge its problems and to take immediate action. This initial commitment is a critical first step, but much work remains to be done and will require a continued dedication of leadership at all levels as well as cooperative arrangements with DOD if savings and efficiencies are to be obtained. DOD has the opportunity to save taxpayers' dollars now and should not defer it.

It will be important that the Army sustain, and even intensify, its efforts under the CFO Act to prepare auditable financial statements building on its first year experience. Implementation of all facets of the CFO Act across government is key to gaining control of the governments finances and providing accountability and stewardship. With the CFO Act, we are at a crossroads in federal financial management. The next few years will be pivotal and show whether agencies are serious about meaningful reform. For their part, the Army and DOD have embarked on a major reform program that has great potential for revolutionizing financial management as we know it today in DOD. Those efforts will require a continuing high priority. In doing so, this immediate actions addressed in my testimony today and called for in our report should be emphasized.

Mr. Chairman, this concludes my prepared statement. I will be pleased to answer any questions from you and the Committee members.

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