

**GAO**

**Testimony**

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**DOD FINANCIAL  
MANAGEMENT**

**More Reliable Information  
Key to Assuring  
Accountability and  
Managing Defense  
Operations More  
Efficiently**

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**G A O**

Accountability \* Integrity \* Reliability

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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss the steps needed to improve financial management at the Department of Defense (DOD). Having reliable, timely financial information is important to ensure accountability over DOD's extensive assets and resources in order to efficiently and economically manage the department. Accomplishing this goal is a tremendous challenge given the worldwide scope of DOD's mission and operations; the diversity, size, and culture of the organization; its estimated trillion dollars of assets and liabilities; and its hundreds of billions of dollars in annual appropriations.

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 system modernization.

Central to achieving accountability are effective financial management operations. However, pervasive weaknesses in DOD's financial management operations led us in 1995 to designate DOD financial management as a high-risk area vulnerable to waste, fraud, abuse and mismanagement--a situation that continues today.<sup>1</sup> Also, taken together, the material weaknesses in DOD's financial operations represent the single largest challenge to getting an unqualified opinion on the U.S. government's financial statements.

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 reporting and to help support the President's goal to obtain an

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<sup>1</sup>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).

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unqualified opinion on the federal government's financial statements. In addition, DOD has recently submitted to the Congress its 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 encompasses over 900 pages and 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.

My comments today will focus on

- the impact of financial management weaknesses on DOD's ability to efficiently and economically carry out its operations;
- efforts DOD has initiated, and additional actions that are necessary, to improve financial management systems and controls in the short term; and
- enhancements needed in updating DOD's Financial Management Improvement Plan--its long-term blueprint for financial management reform.

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## Impact of Financial Management Weaknesses on the Economy and Efficiency of DOD Operations

Recent audits of the fiscal year 1998 financial statements for DOD and the individual military services, performed by the DOD Inspector General (IG) and the service audit agencies, and our report on the U.S. government's financial statements have highlighted many critical DOD financial management problems.<sup>2</sup> These problems not only hamper the department's ability to produce timely and accurate financial management information, but also significantly impair efforts to improve the economy and efficiency of its operations. Key areas of concern relate to ineffective asset control and accountability, which affects DOD's visibility over weapons systems and inventory, and unreliable cost and budget

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<sup>2</sup>See appendix I for a complete list of DOD's 1998 financial statement audit reports.

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information, which affects DOD's ability to effectively measure performance, reduce costs, and maintain adequate funds control.

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## Control and Accountability for Assets Impaired

DOD primarily relies on various logistical systems to carry out its important stewardship responsibility over an estimated \$1 trillion in physical assets, ranging from multimillion dollar weapon systems to enormous inventories of ammunition, stockpile materials, and other military items. These systems are the primary source of information for (1) maintaining visibility over assets to meet military objectives and readiness goals and (2) financial reporting. However, these systems have material weaknesses that, in addition to hampering financial reporting, impair DOD's ability to (1) maintain central visibility over its assets, (2) safeguard assets from physical deterioration, theft, or loss, and (3) prevent the purchase of assets already on hand.

Overall, these weaknesses can seriously diminish the efficiency and economy of the military services' support operations. For example, DOD's lessons learned studies from Operation Desert Storm highlighted combat support problems associated with tracking the status and location of personnel and supplies.

In response to this problem, the department initiated programs or renewed its emphasis on implementing existing measures that would improve asset visibility and tracking. For example, the Global Combat Support System (GCSS), led by the Defense Information Systems Agency, was established in September 1995 to reengineer 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,<sup>3</sup> 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. This includes the equipment and inventory data provided by numerous logistic systems such

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<sup>3</sup>Secondary inventory includes spare parts, clothing, and medical supplies to support DOD operating forces worldwide.

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as the Defense Logistics Agency's (DLA) Distribution Standard System and the Army's Continuing Balance System (CBS-X). As discussed in the following sections, information in these logistic systems on DOD's weapon systems and inventories does not meet accuracy objectives and unless substantive improvements in producing reliable, timely data are made, it will be difficult for efforts such as GCSS and TAV to achieve their objectives.

## Weapon Systems Accountability

While necessary to effectively implement the department's overall objective to maintain visibility over all deployable DOD weapon systems, many of the military services' logistics systems used to track and support weapon systems and support equipment were unable to be relied on to accurately provide information to support DOD's asset visibility and reporting.

Audits of this information in fiscal year 1997 included specific tests to validate the data in the logistics systems reporting military equipment. Because of the sensitive nature of the equipment items selected for existence testing, auditors' fiscal year 1997 financial 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 up to two errors could be identified with the system still receiving a passing grade.

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 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 the following:

- 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

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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 address the issue. The Navy, however, has not yet implemented any significant corrective actions to address deficiencies that continue to impede the Navy's accountability over these weapon systems. Since these problems remained unaddressed, Navy auditors did not repeat these tests for the 1998 audit.

For 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 in 1997, using the pass-fail approach previously discussed, found that the Army 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<sup>4</sup> 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.

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

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<sup>4</sup>Army Logistics Systems: Opportunities to Improve the Accuracy of the Army's Major Equipment Item System (GAO/AIMD-98-17, January 23, 1998).

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correct inaccuracies in CBS-X. The Army Audit Agency 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.

## Inventory Accountability Weaknesses

Audit work has shown that inventory<sup>5</sup> accountability data are inaccurate and include omissions. Further, DOD has large quantities of inventory beyond its requirements that may contribute to its inability to maintain accurate inventory quantity information. Incomplete and inaccurate data will hamper the department's ability to meet and sustain the goals of TAV and other DOD-wide asset visibility initiatives, as well as adversely impact DOD's financial reports. In addition, inaccurate and omitted data increase the risk that responsible inventory item management may request funds to obtain additional, unnecessary inventories of items that are on hand but not reported. Finally, DOD is incurring unnecessary holding costs.

DOD's 1999 Annual Report to the President and the Congress incorporated the TAV initiative goals, including a target of 90-percent visibility of DOD materiel assets by 2000. TAV's longer term target is 100 percent visibility by 2004. The overall objective of TAV is to use the information to improve DOD's logistics practices, including sharing assets within component commands and/or among components. DOD cannot attain its overall TAV objective without both complete and accurate data.

With regard to incomplete inventory data, financial statement audits have found that the department generally excludes information in several inventory accountability systems from financial reports, including reports provided to the 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) over \$9 billion in items warehoused on board ships, (2) over \$3 billion of inventory items held by engineering

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<sup>5</sup>DOD inventory includes ammunition (such as machine gun cartridges, rocket motors, and grenades), consumables (such as clothing, bolts, and medical supplies), repairable items (such as navigational computers, landing gear, and hydraulic pumps), and stockpile materials (such as industrial diamonds, rubber, and tungsten).



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and ordnance activities, and (3) \$650 million of items at redistribution centers. In addition, about \$19 billion of government owned material held by contractors is omitted from inventory reports provided to the Congress.

With regard to accurate inventory data, financial audits have repeatedly found large differences between on hand and recorded inventory quantities. For example, in 1996 the DOD IG reported an overall 24-percent error rate at DOD's primary storage locations. In 1997, Navy auditors reported a 23-percent error rate for the 13 major storage locations they visited. Finally, in 1998, for the 14 depots we visited holding 82 percent of depot inventory, the reported depot accuracy rates were below DLA's targeted 95-percent accuracy mark, with only 2 depots reporting inventory record accuracy rates above 90 percent. Further, our preliminary observations over the physical inventory count procedures and the accuracy of those rates show that improvements are needed to strengthen controls over inventory. We will soon be providing DOD with specific recommendations on how it can improve these inventory controls.

The sheer size and volume of DOD's on-hand inventories also impede the department's efforts to accumulate and report accurate inventory data. We reported in our high-risk reports on defense inventory management that the department needs to avoid burdening its supply system with large unneeded inventories.<sup>6</sup> In our soon to be released report, we stated<sup>7</sup> that about 60 percent of on-hand items, or an estimated \$39.4 billion of DOD's secondary inventory, exceeded DOD's requirements. The DOD IG has also recently reported that about \$3 billion of DLA's reported \$9.8 billion of consumable inventory was inactive and of uncertain future utility. DOD acknowledges the need to reduce its inventories and has established goals to reduce supply inventory by \$12 billion by 2000.

Finally, inaccurate or incomplete data can result in unnecessary purchases. In addition, unneeded inventory incurs holding costs. 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

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<sup>6</sup>Major Management Challenges and Program Risks: Department of Defense (GAO/OCG-99-4, January 1999).

<sup>7</sup>Defense Inventory: Status of Inventory and Purchases and Their Relationship to Current Needs (GAO/NSIAD-99-60, April 16, 1999).

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already in excess supply.<sup>8</sup> In addition, we estimated<sup>9</sup> that the services could save about \$382 million annually in inventory holding costs by eliminating at nonmajor locations inventory that is not needed to meet current requirements.

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## Reliable Cost Information Not Available

Reliable information on the cost of operations and the use of budgetary resources is critical to provide accountability for, and to efficiently and economically manage, DOD's vast resources. Both cost and budgetary information are essential for making important decisions, such as reallocating resources to our fighting forces and considering whether to continue, modify, or discontinue programs and activities. However, DOD's financial management systems are not designed to capture the full cost of its activities and programs. Also, as the next section discusses further, certain information on DOD's budget resources is unreliable

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. The lack of reliable, cost-based information hampers DOD in each of these areas, as discussed below.

## Evaluating Programs

Accurate cost information is needed to evaluate the results of management's decisions, including determining whether anticipated savings have been achieved. In this regard, we recently reported<sup>10</sup> that DOD relied on budget estimates and projections to determine its estimated savings from base closure activities. We concluded that because of data and record weaknesses, DOD's estimates should only be viewed as

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<sup>8</sup>Defense Logistics Much of the Inventory Exceeds Current Needs (GAO/NSIAD-97-71, February 28, 1997).

<sup>9</sup>Defense Inventory: Spare and Repair Parts Costs Can be Reduced (GAO/NSIAD-97-47, January 17, 1997).

<sup>10</sup>Military Bases: Review of DOD's 1998 Report on Base Realignment and Closure (GAO/NSIAD-99-17, November 13, 1998).

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providing a rough approximation of costs and savings rather than a precise accounting.

In addition, long-term liabilities that affect program costs must be accurately measured and considered in evaluating the status of programs. Without adequate cost data to help determine liabilities, DOD may be over- or understating the future resources that will be required to meet its commitments. For example, inadequate cost data inhibit DOD's ability to accurately estimate the projected costs of providing health care benefits to future military retirees and their beneficiaries. Currently, for financial reporting, DOD estimates its liability using unaudited budget information, which does not include the full cost of the program. For example, the costs of the treatment facilities and some personnel costs such as pension benefits may not be fully captured. As a result, the liability could be substantially different from the reported balance.

Further, DOD's lack of reported cost data on the disposal of weapon systems, including for example, aircraft, missiles, ships, and submarines, was a significant factor contributing to our conclusion that the liability for such costs on the federal government's financial statements was understated.<sup>11</sup> The liability for this disposal activity is a part of the overall life cycle cost of these weapon systems and can contribute to the ongoing dialogue on funding comparable weapon systems.

## Making Economic Choices

DOD's decisions on whether to outsource specific functions are undermined without supporting cost data. Yet DOD, as well as other government agencies, has historically been unable to provide actual data on the costs associated with functions to be considered for outsourcing, particularly with respect to overhead rates. Consequently, to ease concerns about unfair competition, OMB selected a single overhead rate (12 percent) for DOD and other federal agencies to use in A-76 competitions.

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<sup>11</sup>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 Liabilities for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997), and Financial Management: DOD's Liabilities for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).

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We recommended<sup>12</sup> that DOD develop overhead rates that better reflect actual overhead costs, which would promote fairer competition between the government and private sector. Further, DOD is unable to capture complete and reliable data on the capital costs associated with its operations, which adversely affects its ability to develop cost information to compare with the private sector. Specifically, billions of dollars of existing DOD plant, property, and equipment assets have been expensed and, as a result, the costs associated with their acquisition and use may not be adequately considered.

Further, inadequate cost information diminishes DOD's ability to manage military health treatment in areas such as allocating resources, deciding whether to provide services internally or by outsourcing, setting third-party billing rates, and benchmarking its health delivery system with those of other providers. Specifically, the preliminary results of our review of key DOD data for estimating these costs identified inconsistent data collection and reporting and incomplete accounting for all relevant expenses and revenues.

Finally, the Clinger-Cohen Act mandates performance-based and results-oriented information for all major information technology (IT) investments. As we have reported,<sup>13</sup> lack of cost information prevents DOD from properly compiling the total cost of its IT investments, as required by the Clinger-Cohen Act. This impedes DOD in meeting the act's requirement to establish goals for improving efficiency through effective use of information technology and benchmarking agency process performance against comparable processes in terms of cost, benefits, and risk.

## Controlling Costs

Two of the most prominent areas where DOD has stated a need for more accurate data to control costs are in its weapon systems activities and its working capital fund operations. Specifically, DOD acknowledges 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. Without accurate information on the life-cycle costs of weapon systems, neither DOD officials nor Congress can make fully informed decisions about which

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<sup>12</sup>Defense Outsourcing: Better Data Needed to Support Overhead Rates for A-76 Studies (GAO/NSIAD-98-62, February 27, 1998).

<sup>13</sup>Defense Information Management: Continuing Implementation Challenges Highlight the Need for Improvement (GAO/T-AIMD-99-93, February 25, 1999).

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weapons, or how many, to buy. DOD is developing, by 2000, a system intended to provide management with improved insight into total costs and the information necessary to make more informed decisions.

DOD also 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--its primary customers. The foundation for achieving the goals of these business-type funds is accurate cost data, which is critical for them to operate efficiently.

DOD working capital funds charge their customers prices for the support operations provided so that they can recover the full cost of the goods and services provided, including administrative and overhead costs. Every dollar that the military services spend inefficiently on DOD working capital fund purchases results in fewer resources available for other defense spending priorities. Simply stated, working capital fund overcharges could result in the military services using more Operations and Maintenance appropriations in the current year than anticipated; undercharges could result in unanticipated future pricing increases and funding requests.

In recent financial audits of DOD working capital funds, auditors found large adjustments to the value of inventory balances. For example, the Air Force and the Army working capital funds had gains and losses of \$21 billion and approximately \$3.1 billion, respectively, resulting from physical inventory and accounting adjustments. Such large inventory gains and losses, which often were not investigated, are likely to have a significant impact on the funds' costs of operations and the prices charged to the funds' customers for goods and services provided.

Finally, DOD working capital funds set sales prices based on projected operating costs and cash flows. In recent years, there have been large fluctuations in prices charged. For example, the Navy surcharge increased from 14 percent in 1996 to 27 percent in 1997 and to 57 percent in 1998, impacting the sales price to customers. For example, an item with an acquisition cost to the working capital fund of \$100 in 1996 would have been sold for \$114 in 1996, \$127 in 1997, and \$157 in 1998. Fluctuations of this type make it difficult for the funds' customers to budget the future costs of repairables and other goods and services, leading to funding shortfalls that could affect operations and readiness.

## Measuring Performance

DOD is unable to develop reliable, cost-based performance indicators and measures across virtually the entire spectrum of its operations. As part of

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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.<sup>14</sup> Most programs have some form of associated cost consequences that can be directly or indirectly measured and should be considered in assessing program achievement.

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## Reliable Budgetary Data Essential

In addition to accurate cost data, reliable budget information is essential to ensure that spending of appropriated funds complies with the amount, purpose, and time frame designated by the Congress. To help ensure that this occurs, DOD has implemented systems and controls it relies on to (1) record obligations when it orders goods and services and (2) liquidate the obligations by disbursing funds when goods and services are received. Effective obligation and disbursement practices are essential to ensure that DOD's spending does not exceed appropriated amounts and other spending limits imposed by the Congress.

As part of the DOD fiscal year 1998 financial statement audit, auditors found several areas, however, in which the systems and controls over the department's use of its budgetary resources were ineffective. These control weaknesses have left DOD in a situation where it does not know the true amount of funds that are available to obligate and spend in each appropriation account. This situation occurs because obligated balances are not always correct, reconciliations between DOD and Treasury records are not being adequately performed, and certain disbursements are not being recorded promptly in DOD's accounting records. Either overspending or cancellation of funding authority (not dispersing funds during the period they were made available for spending by Congress results in cancellation of the authority) can result.

## 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 for its general funds were found to be incorrect or unsupported. Further, review of unliquidated Navy contract obligations showed that approximately 17

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<sup>14</sup>Results Act: DOD's Annual Performance Plan for Fiscal Year 1999 (GAO/NSIAD-98-188R, June 5, 1998).

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percent of the amounts tested (\$101 million of \$592 million) were no longer correct. Army auditors also found evidence of unsupported obligations but were unable to quantify the extent of the problem.

**Reconciliations Not Adequately Performed**

DOD's records on its available funds should be reconciled to Treasury records just as an individual reconciles his or her checkbook to a bank statement. However, comparison of the two records resulted in unresolved differences amounting to \$9.6 billion. These unresolved differences could significantly affect the status of budget authority available to be obligated and expended.

Further, DOD's records 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 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 proper DOD transactions and that its disbursements do not exceed appropriated amounts. Moreover, this reported amount represents netting of collections and adjustments against disbursements, thus understating the magnitude of the problem. For example, as part of our fiscal year 1997 financial audit, we found that while the Navy had a net balance of \$464 million in suspense accounts recorded in its records, the individual transactions, collections as well as disbursements, totaled about \$5.9 billion.

**Disbursements Not Properly Recorded**

The concerns the auditors raised with respect to 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 reported these problems 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 an obligation. This obligation could create an Antideficiency Act violation if the department's available unobligated balance was 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'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

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available budgetary resources as of September 30, 1998. In addition, as we previously reported,<sup>15</sup> 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.

The problems affected the reliability of both obligation and disbursement data. As a result, the Congress cannot be assured that DOD did not overexpend its budget authority 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 manage remaining budget authority, so that funds the Congress intended for specific DOD programs may be unused and eventually canceled. For example, at the end of fiscal year 1998, the department had \$4.3 billion in expired budget authority that was allowed to cancel.

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## Short-Term Financial Management Improvement Efforts Essential

Fully resolving many of DOD's financial management deficiencies will require long-term actions and technology improvements, as discussed in the next section. In the interim, however, DOD must work to improve its existing financial management systems through short-term corrective actions. These efforts focus on improving the credibility of DOD's financial information to improve the reliability of year-end financial statements for DOD and the government as a whole--and on making efforts to strengthen the integrity and controls over existing underlying financial and logistical systems.

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. Several of the actions included in DOD's short-term plan, along with additional short-term actions necessary to provide a solid foundation for the department's financial management improvement efforts, are highlighted below. These include actions that are needed to (1) ensure feeder system data accuracy,

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<sup>15</sup>Financial Management: Problems in Accounting for Navy Transactions Impair Fund Control and Financial Reporting (GAO/AIMD-99-19, January 19, 1999).



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(2) implement accounting policy guidance, (3) instill fundamental controls, and (4) train financial management personnel.

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## Ensuring Accuracy of Feeder System Data

About 80 percent of the data now relied on for financial management comes from department program operating systems such as logistics, acquisition and personnel. For example, the department relies on data from its personnel systems to provide data to its payroll systems. Effective controls to ensure that only valid and accurate transactions are initially entered into the department's feeder systems on a timely basis is critical to obtaining reliable data through the department's existing system structure. It also is necessary to achieve an effective transition to the department's envisioned future integrated system structure.

The department has acknowledged, and audit reports have confirmed, that the data produced by many of these feeder systems are not yet reliable. Specifically, auditors have identified problems in the accuracy of the department's feeder systems data relied on to provide information ranging from plant, property, and equipment to the cost of military retiree health benefits to weapon and inventory systems.

To help eliminate inaccurate payments in the department's military payroll system, DOD has reported that an interface between its military personnel systems and its military payroll system is scheduled for completion in 2000. As part of their fiscal year 1998 financial audit, Army auditors continued to report major mismatches between military personnel and payroll data, a condition that was previously identified in 1993. The planned interface should reduce some problems identified with inappropriate payments to military personnel; however, it will only do so to the extent that data on personnel actions are entered to the interfaced personnel system accurately and in a timely manner. Until this interface is operational, the Army intends to compare and reconcile military payroll and personnel data monthly.

DOD also has short-term plans calling for a number of actions by high-level functional and financial personnel intended to improve the accuracy of DOD's inventory, property, plant, and equipment, and military retiree health benefit feeder system data.

## Inventory Accountability Data

The DOD Comptroller and Under Secretary of Defense for Acquisition and Technology are responsible for a set of actions intended to improve the accuracy of data in its inventory accountability systems. Specifically, they

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plan to require inventory holders to evaluate how inventory transactions (e.g., receipts and issues) are processed, determine the sources and causes of processing errors, and develop a remedial plan for correcting those errors. In addition, they intend to improve the department's inventory sampling and physical count procedures to provide more accurate and meaningful rates for measuring the accuracy of inventory records.

**Plant, Property, and Equipment Data**

The DOD Comptroller and 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 by obtaining contractor support for testing the validity of cost data currently in accountability systems. If the current systems' cost data are found to be unsupported, the contractor will develop a methodology for approximating historical cost and the required accumulated depreciation for those assets.

**Military Retiree Health Benefit Data**

The Under Secretary of Defense for Personnel and Readiness is responsible for providing more reliable data for estimating the future cost of military retiree health benefits. DOD has developed a high-level data quality task force to ensure that financial, labor utilization, and workload data in its primary health care cost system are reconcilable to data in respective source documents and support systems.

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**Implementing Accounting Policy Guidance**

The department also has plans to implement new or revised federal accounting policies in several areas. For instance, we have reported that DOD is not following federal accounting standards for accounting for environmental and disposal liabilities associated with certain major weapons systems such as aircraft, missiles, ships, and submarines. To provide better information on these liabilities, DOD is developing policies and procedures to estimate (1) the expected restoration costs for contaminated site and hazardous waste removal and (2) the disposal costs for ammunition, chemical weapons, excess and obsolete structures, and major weapons systems. Also, to better account for inventory, DOD is improving procedures related to inventory gains and losses, determining the value of depot-level repairable inventory, and estimating the cost of beginning inventory balances.

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**Instilling Fundamental Control**

DOD has long-standing control deficiencies, including serious computer security weaknesses. DOD's plans call for ensuring that existing

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rudimentary accounting and control policies and procedures are followed, through such means as reconciliations of its Fund Balance With Treasury accounts and its inventory asset accounts. We have made a number of recommendations to DOD to instill greater discipline by adhering to fundamental controls. For example, we recently recommended that the department better ensure that existing vendor payment controls are followed, including limiting the number of personnel with access to pay systems. DOD has begun a departmentwide initiative to review access to such systems to identify individuals with unneeded access.

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## Training Financial Management Personnel

One of the key issues facing DOD is the need to ensure that its financial management staff has the knowledge and skills required to carry out complex financial management operations. Our work<sup>16</sup> 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 management training during 1995 and 1996.

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 the 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.

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<sup>16</sup>Financial Management: Profile of Financial Personnel in Large Private Sector Corporations and State Governments (GAO/AIMD-98-34, January 2, 1988).

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## Updates to Long-Term Improvement Plan Need to Incorporate Additional Elements

Completing short-term actions can improve DOD's financial information and ultimately even result in auditable financial statements. However, an unqualified audit opinion, while certainly important, is not an end in itself. For some agencies, the preparation of financial statements requires considerable reliance on ad hoc programming and analysis of data produced by inadequate systems that are not integrated or reconciled, and often requires significant audit adjustments. Efforts to obtain reliable year-end data that are not backed up by fundamental improvements in underlying financial management systems and operations to support ongoing program management and accountability will not achieve the intended results of the Chief Financial Officers Act--reliable financial management information to support day-to-day decision-making over the long term. Thus, it is essential that DOD also undertake and complete long-term efforts to improve financial management systems and processes.

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. Section 912 of the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 (Public Law 105-261) required GAO to analyze DOD's Biennial Plan and discuss the extent to which it is a workable plan for addressing DOD's financial management problems.

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.

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We have analyzed DOD's first plan and, in January 1999, reported<sup>17</sup> the results of our analysis to the Senate and House Armed Services Committees. As we said 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, modifications to the plan are needed if DOD is to achieve the full range of reforms needed. To accomplish this, the department's planned update should include

- a revised concept of operations to reflect, at a high level, the full range of the department's financial management operations, including its key asset accountability and budget formulation responsibilities;
- specific plans on shared servicing and outsourcing strategies;
- clarification in the transition plan of the role of each of the described initiatives 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; and
- concepts established in the Clinger-Cohen Act for effectively implementing the technology initiatives contained in the plan.

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## Revised Concept of Operations

While the plan's discussion of how DOD's financial management operations will work in the future--its concept of operations--is a good start, it is not complete. It does not address how (1) it will support budget formulation

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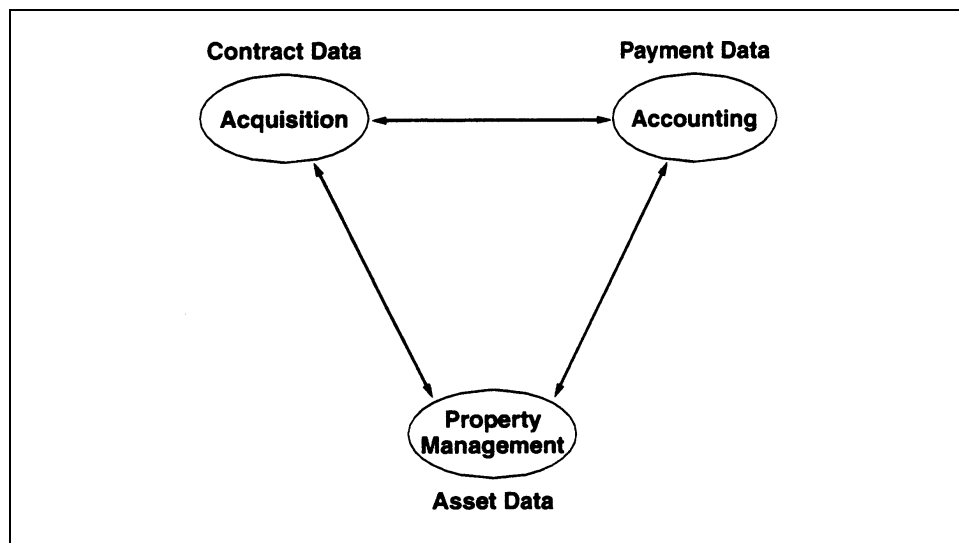
<sup>17</sup>Financial Management: Analysis of DOD's First Biennial Financial Management Improvement Plan (GAO/AIMD-99-44, January 29, 1999).

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and (2) its financial management operations will effectively support not only financial reporting but also asset accountability and control. DOD stated that it intentionally excluded budget formulation from its concept of operations because it is performed as part of the department's Planning, Programming, and Budgeting System (PPBS). However, budget formulation is one of the central processes involved in any agency's financial management operations and must be included in the department's concept of operations to develop a fully integrated financial management system that ensures that budgets consider financial implications and that policy decisions are based on sound financial information.

To effectively support accountability and control, DOD's systems need to share information. However, the flow of information among functional areas, such as how acquisition will share information with property management, is not clear in DOD's plan. The figure below is a simplified example of how a financial management system for asset acquisition shares information to help achieve greater control and accountability.

**Figure 1: Example of How Systems Integration Helps Achieve Greater Control**



As shown in this figure, contract data are entered initially by acquisition personnel when an asset is ordered. This information would be available to accounting personnel to record the obligation and to property management to recognize that an asset is to be delivered. Upon asset receipt, property management personnel enter the asset in property management records.

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Those records are available for accounting personnel for payment purposes, for acquisition personnel to monitor contract delivery, and for property management personnel to monitor program results and the use of budgetary resources. Greater asset control and accountability is achieved because data associated with assets acquired are available to accounting, property management, and acquisition personnel.

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## Shared Servicing and Outsourcing Strategies

Many leading organizations have reduced the cost of, and increased the control over, day-to-day accounting activities by processing routine accounting functions at a reduced number of locations, known as shared service centers. These shared service centers provide common services such as accounts payable, fixed asset, and payroll processing to operating locations and business units. In this regard, the National Defense Authorization Act for fiscal year 1998 required the department to address in its first biennial Financial Management Improvement Plan the feasibility of reorganizing DFAS along functional lines.

Preliminary results from a study we are completing on financial management best practices indicate that many leading organizations we identified, including the six we visited, used a shared services strategy. While several different organizational structures were used to apply the concept, many followed three stages in implementing this strategy. The first stage is consolidation and includes changing the organizational structure and gaining control over the current business processes. The second stage is standardization and entails changing the current business processes and adopting a common technology platform. The final stage is reengineering and includes leveraging technology through the use of electronic commerce, data warehousing, and document imaging.

To date, DFAS has consolidated the activities of 332 installation finance and accounting offices at its headquarters, 5 centers, and 19 operating locations and intends to further consolidate locations. The plan states that DFAS processes are most efficiently performed at a minimal number of locations. As the number of systems is reduced, the number of separate operating locations necessary to operate the systems is also reduced. However, the plan did not provide additional information on the number or nature of the required locations. We will continue to examine this area.

The fiscal year 1998 authorization act also required that the plan address the feasibility of outsourcing DOD's accounting operations. While DOD's plan identified certain functional areas, such as commissaries and retired

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annuitant pay, for outsourcing studies under A-76, the plan needs to more clearly articulate a competitive outsourcing strategy. For example, our October 1997 report<sup>18</sup> on the results of our survey of selected private sector and nonfederal public organizations' use of outsourcing identified several factors associated with successful outsourcing.

One of the key factors was establishing a competitive outsourcing policy that specifies what process and criteria the organization will follow in making competitive outsourcing decisions to achieve its overall goals. This policy at DFAS might include (1) an outsourcing structure by which the functional areas to be considered for outsourcing are identified and (2) criteria to be used in determining whether or not to outsource a specific function, such as personnel losses, decreased costs, or economic impact to the community. In addition, a schedule with specific time frames for competitively bidding DFAS functions and deciding whether or not to outsource them might be added later. Finally, after an organization decides to outsource, it is key that effective oversight controls be in place to ensure that vendors carry out their responsibilities. Establishing a competitive outsourcing policy that includes these elements as well as adequate oversight controls is fundamental to achieving the projected cost savings, process cycle time reductions, and other related financial management improvement goals established by the department.

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## Clarification of Transition Plan

In addition, the transition plan, while an ambitious statement of DOD's planned improvement efforts, has two important limitations: (1) links are not provided between the envisioned future operations and the over 200 planned improvement initiatives to determine whether the proposed transition will result in the target financial management environment and (2) actions to ensure feeder systems' data integrity are not addressed--an acknowledged major deficiency in the current environment. Without identifying specific actions that will ensure ongoing feeder system data integrity, it is unclear whether the department will be able to effectively carry out not only its financial reporting, but also its other financial management responsibilities.

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<sup>18</sup>Financial Management: Outsourcing of Finance and Accounting Functions (GAO/AIMD/NSIAD-98-43, October 17, 1997).



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## Concepts of Clinger-Cohen

Effective implementation of the modernized systems outlined in the Biennial Plan will require following well defined practices for managing investments in information technology--practices that have been lacking in DOD and other agencies across government. Several recent management reforms have introduced requirements emphasizing the need for federal agencies to significantly improve their management processes, including how they select and manage IT resources. For instance, the Clinger-Cohen Act requires agencies to have processes and information in place to help ensure that IT projects are being implemented at acceptable costs, within reasonable and expected time frames and are contributing to tangible, observable improvements in mission performance. We recently testified<sup>19</sup> before the House Committee on Armed Services' Subcommittee on Military Readiness about a number of serious management challenges DOD faces regarding technology-driven processes and business systems. Specifically, we highlighted DOD's lack of effective fundamental management and oversight controls for (1) assessing the costs and risks of proposed information technology projects, (2) ensuring that projects follow departmentwide technical and data standards, (3) measuring performance, and (4) discontinuing projects shown to be technically flawed or not cost effective. DOD has efforts underway to implement required reforms but a great deal more effort is needed. Unless DOD successfully implements these broader information technology reforms, it will be limited in its ability to achieve the financial management system goals outlined in its Biennial Plan.

While there is a need to address these problems over the long term, we recognize that in the short term the department still must focus on the Year 2000 computing challenge. However, DOD has a unique opportunity to capitalize on the valuable lessons it has learned in its Year 2000 effort and apply them to its overall management of financial management and information technology. Doing so can enable the department to acquire and deploy high performing, cost-effective systems and to avoid repeating costly mistakes. Examples include the following:

- Without the continuing, active involvement of top-level managers, major management reform efforts cannot succeed.

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<sup>19</sup>Defense Information Management: Continuing Implementation Challenges Highlight the Need for Improvement (GAO/T-AIMD-99-93, February 25, 1999).

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- 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 or 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 Initiatives to include financial management. Achieving real 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.

In closing, Mr. Chairman, sustained congressional attention on DOD's efforts to reform its long-standing financial management weaknesses, provided in hearings such as this one, will also be critical to ensuring that DOD is able to provide accountability to the taxpayers and to meet its operational goals as efficiently and effectively as possible.

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

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# DOD Fiscal Year 1998 Financial Statement Audit Reports

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Department of Defense Agency-wide Financial Statements (March 1, 1999, DOD IG 99-097)

Army General Fund Financial Statements (February 18, 1999, AA 99-158)

Army Working Capital Fund Financial Statements (February 19, 1999, AA 99-160)

Army Corps of Engineers, Civil Works Financial Statements (February 8, 1999, AA 99-157)

Air Force General Fund Financial Statements (March 1, 1999, AFAA Project 98053002)

Air Force Working Capital Fund Financial Statements (March 1, 1999, AFAA Project 98068013)

Navy General Fund Financial Statements (February 10, 1999, NAS 024-99)

Navy Working Capital Fund Financial Statements (February 22, 1999, NAS 027-99)

Defense Logistics Agency Working Capital Fund Financial Statements (March 1, 1999, DOD IG 99-089)

Defense Finance and Accounting Service Working Capital Fund Financial Statements (March 1, 1999, DOD IG 99-090)

Military Retirement Trust Fund Financial Statements (March 5, 1999, DOD IG 99-104)

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