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Testimony

Statement
of
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Office of the Inspector General
Department of Defense
to the
Subcommittee on Government Efficiency
and Financial Management
House Government Reform Committee
on
Defense Financial Management

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Department of Defense
Office of the Inspector General

Quality

Integrity

Accountability

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to provide the views of the Office of the Inspector General of the Department of Defense on financial management, which continues to rank as one of the Department's most difficult management improvement challenges. I would like to begin by noting the fundamental fiduciary responsibility of the Department of Defense, which is to manage assets purchased with taxpayer dollars effectively and efficiently. The American taxpayer should expect no less than that: Article I, Section 9 of the Constitution stipulates that: "a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." Accordingly, the Chief Financial Officers Act, as amended, describes the Inspector General's responsibility for auditing the financial statements of the Department of Defense.

The importance of reliable financial information is reiterated by recent military actions in Afghanistan and Iraq. Decision-makers responsible for planning military actions need reliable financial information so that they can prudently manage available resources and allocate dollars to those processes that yield maximum support for the war fighters. I am pleased to report to you today that the Department of Defense has undertaken an ambitious task to overhaul its financial management systems and business processes. However, current financial statements remain generally unreliable.

Opinions on Financial Statements for FY 2002

In terms of audit opinions, I wish we could report more significant progress in achieving a favorable audit opinion for the Department. For FY 2002, we again issued a disclaimer of opinion for the Department of Defense Agency-Wide Financial Statements because serious deficiencies continue to exist related to the quality of data, adequacy of

reporting systems, and reliability of internal controls. We also issued a disclaimer of opinion on all but one of the major reporting entities. As in past years, we issued an unqualified (clean) opinion for the Military Retirement Fund's financial statements. We continue to support the Senate Select Committee on Intelligence's objective to improve financial reporting within the intelligence community. Unfortunately, we found that the National Security Agency, Defense Intelligence Agency, and the National Imagery and Mapping Agency continued to produce unreliable financial statements because they lack compliant accounting systems, did not devote adequate resources to financial operations, and had not implemented prior audit recommendations. (Attachment 1 shows the reporting entities for 2002 and the number of financial statements required for each reporting entity.) Four other Department of Defense agencies¹ whose funds are not large enough to require separate reporting to the Office of Management and Budget have received unqualified opinions from independent public accounting firms. That is a positive sign, but the impact of these statements is minimal on the Department of Defense Agency-Wide Financial Statements because the balances are not significant.

Internal Control Deficiencies

Data reliability, integrity, timeliness and auditability continue to impede our ability to render an opinion on the financial statements. The Department has readily acknowledged that many of its financial management and feeder systems do not produce adequate data to support various material amounts on the financial statements. We reported the following material control deficiencies in our audit report for the FY 2002 Department of Defense Agency-Wide Financial Statements:

¹Defense Contract Audit Agency, Defense Commissary Agency, Defense Finance and Accounting Service, and the Defense Threat Reduction Agency

- Financial Management Systems. As a result of the Department-wide deficiencies in financial systems and business practices, the Department is unable to collect and report financial performance information that is timely, accurate, and reliable.
- Intragovernmental Eliminations and Other Accounting Entries. Most intragovernmental transactions cannot be reconciled. Therefore, related adjustments cannot be verified. Also, the Department continues to record material amounts of unsupported accounting entries as they prepare their financial statements for audit.
- Fund Balance with Treasury and Problem Disbursements. A significant dollar value of disbursements is not accurately reported. Uncleared differences exist between cash transactions reported by the Department and the Treasury Department's records. Also, disbursements are not properly matched to specific obligations in accounting systems.
- Military Retirement Health Care Liabilities. The quality of direct care data in the military health care system affected the accuracy of the unfunded liability.
- Environmental Liabilities. The Department has difficulty estimating the environmental liabilities because of problems with guidance, audit trails, estimating models, and site inventories.
- General Property, Plant and Equipment. The value of General Property, Plant, and Equipment is not reliably reported due to lack of supporting documentation.
- Government-Furnished Material and Contractor Acquired Material. The value of Defense property and material in the possession of contractors is not reliably reported.
- Inventory. The existing inventory valuation method does not produce an auditable approximation of historical cost because the associated gains and losses cannot be accurately tracked to specific items or purchases.

- Operating Material and Supplies. The Department's systems were designed to expense materials when purchased rather than when consumed, which causes the true value of this inventory account to be unknown.
- Statement of Net Cost. The Statement of Net Cost is presented by appropriation categories that cannot be aligned with the major goals and outputs described in the Department's strategic plan and performance measures.
- Statement of Financing. The Department cannot reconcile budgetary obligations to net cost without making adjustments.

Other Recent Audit Results

Although the annual audit opinions may continue to attract more attention than other individual audit reports, the Department's progress in addressing the specific findings and recommendations of individual reports will be a critical factor in determining how much financial management improvement actually occurs. The following examples show the variety of financial management challenges that the Department faces.

--When the Defense Finance and Accounting Service began taking steps to close down their old contract disbursing system (MOCAS), nearly 4,000 old contracts with unpaid invoices surfaced. The unpaid invoices totaled approximately \$97 million. Some contracts were improperly funded from cancelled appropriations. Various Defense entities had not identified funding to make payments, and prompt payment penalties were accruing. The Department needed to find current funding to pay the invoices so that the contracts could be closed. (Report D-2002-076)

--Since July 2002, the Inspector General issued 13 reports in support of the Federal Information Security Management Act, which requires Government-wide, cost-effective policies for security of Federal information systems. Eight of the reports discussed financial systems. We found a variety of security-related problems in these audits. For example, In December 2002, we reported that the Defense Finance and Accounting Service had not fully implemented information security controls for a system used by the Military Departments. The numerous material weaknesses indicated that controls were not in place to detect or prevent unrestricted access or fraudulent payments. The weak controls led to at least \$500 thousand of fraudulent payments in the past 6 years. Management was awaiting implementation of a new system to correct control weaknesses; however, implementation had been delayed. Management agreed to correct the weaknesses when we brought the problems to their attention. (Report D-2003-035)

--A series of three OIG audits identified hundreds of millions of dollars of deferred maintenance not identified and reported on the financial statements. The Military Departments were not consistently and accurately compiling deferred maintenance information on weapons systems. Also, the Military Departments did not collect information on all maintenance actions funded by the Operation and Maintenance appropriation, did not perform a required reconciliation between deferred maintenance information and budget documentation, and did not collect information on deferred maintenance incurred on support ships. (Reports D-2003-030, D-2003-054, D-2003-058)

--In two audits discussing Navy assets, we reported significant misstatements: The Navy materially misstated inventory by about \$500 million because its revaluation methodology was incorrect. (Report D-2003-039) The Navy also

incorrectly classified \$6.9 billion in principal end items as operating materials and supplies that would be used in normal operations. (Report D-2003-020)

Congressional Guidance

Section 1008 of the National Defense Authorization Act for FY 2002 directed the Office of the Inspector General of the Department of Defense, when auditing the year-end financial statements, to perform only the minimum audit procedures required by auditing standards when management acknowledges the financial statements are unreliable. We have long advocated that resources should not be expended to conduct costly audits to produce a disclaimer of opinion at year-end.

We agree with the rationale behind Section 1008 and we have complied with those requirements in performing our audits of the FY 2002 Department of Defense-Wide Financial Statements and 6 of the other required reporting entities. We were able to efficiently plan limited audit procedures commensurate with management representations that we received from the Office of the Under Secretary of Defense (Comptroller) and Military Departments. The Military Retirement Fund and U.S. Army Corps of Engineers, Civil Works management represented their financial statements were fairly presented and we initiated a full scope audit.

Generally the financial management weaknesses acknowledged by management were of such a magnitude that they enabled us to limit our audit work and issue disclaimers. However, those known weaknesses may represent the tip of the iceberg. We recognize, and have advised Department of Defense management, that additional weaknesses may be identified in the future when we initiate detailed financial statement audit work in response to management's improved representations. To mitigate the risks

of new weaknesses surfacing during the financial statement audits, we have encouraged Department of Defense management to rigorously and thoroughly review the impact of corrective actions.

U. S. Army Corps of Engineers

On September 18, 2002, the U.S. Army Corps of Engineers, Civil Works management represented that their FY 2002 financial statements would be fairly presented in all material respects and in accordance with Generally Accepted Accounting Principles. After initiating our audit effort, the Corps realized that audit-ready evidential matter was not readily available for our review, and as a result we issued a disclaimer of opinion in January 2003. We are continuing extensive financial audit work in the Army Corps of Engineers, Civil Works, and we are finding additional problem areas. The Army Corps of Engineers is taking aggressive actions to correct problems as they are identified.

The audit of the U.S. Army Corps of Engineers, Civil Works has demonstrated the magnitude of the effort required to perform comprehensive audits on Department of Defense entities. In supporting our disclaimer of opinion on the Balance Sheet, 120 auditors were involved in performing audit work. Additional auditors will be needed to audit larger components. For example, the U.S. Army Corps of Engineers, Civil Works reported \$43 billion in assets and \$12 billion in Budgetary Resources. However, the Army General Fund reported more than \$90 billion in assets and \$112 billion in Budgetary Resources. The Office of the Inspector General will require additional audit resources as other Department of Defense components assert that previously reported

problems have been corrected and data supporting the financial statements is auditable and reliable.

Business Management Modernization Program

The Department of Defense has numerous business systems performing a myriad of tasks. These systems are often characterized by multiple systems performing the same tasks, the same data stored in multiple systems, manual data entry and reentry into multiple systems, and extensive data translations. These characteristics limit data integrity and require extensive efforts by management to compile financial statements. The current initiative by the Office of the Under Secretary of Defense (Comptroller) in establishing the Department of Defense Business Management Modernization Program Office supports the course mandated by Section 1008 to correct system weaknesses prior to expending significant efforts to compile and audit the Department's financial statements. On April 30, 2003, the Business Management Modernization Program delivered the initial Business Enterprise Architecture (Architecture), which is currently in the implementation phase. The Architecture is essentially a blueprint describing the Department's future financial management systems and processes. The blueprint and its associated transition plan will be the basis for financial reform in the Department. Full implementation of the Architecture will allow the Department to comply with Federal accounting and financial management reporting requirements, especially those mandated by the Federal Financial Management Improvement Act of 1996. The Architecture also provides an approach that leads to the integration of budget, accounting, and program information and systems. We believe that the effort to establish a comprehensive business systems architecture is a necessary and long overdue step. The General Accounting

Office is evaluating the architecture as required by the FY 2003 National Defense Authorization Act.

In preparation for the Architecture, the Business Management Modernization Program was required to compile a Department of Defense business systems inventory. On May 9, 2003, the Business Management Modernization Program reported an inventory of 2,274 business systems. However, this inventory still may not be complete and the Under Secretary of Defense (Comptroller) will need to continue to work with the Assistant Secretary of Defense for Networks Information Integration to develop a single source for business systems information to enhance implementation of the Architecture.

There are undeniable risks—implementation of the Architecture could take much longer than anticipated, the cost to implement the architecture might be prohibitively expensive, and the Department may lack the discipline to make system program managers conform to the architecture over an extended period of time. The Department has taken a major step forward by accepting the premise that the business management improvement effort needs to be treated as a program, with all of the appropriate controls required of a very large program. Those include a master plan, well-defined management accountability, full visibility in the budget, regular performance reporting, and comprehensive audit coverage. Until the Department installs its new financial management architecture and integrated systems, it must rely on work-arounds and manual compilations of financial data that are prone to errors. We believe that the Department of Defense is making a good faith effort to create a strong management structure for the systems improvement effort. We look forward to assisting the Department in this endeavor.

Additional Challenges

In addition to the need for comprehensive financial systems to enable the Department to achieve audit opinions on the financial statements, the Department faces additional challenges related to accelerated reporting requirements, the new requirement to include military equipment on the financial statements, and implementing numerous open recommendations from prior audits.

Like other Federal entities, the Department of Defense is faced with the challenge of submitting the FY 2004 audited financial statements to the Office of Management and Budget by November 15, 2004. The Department has voluntarily taken action to accelerate the reporting schedule for FY 2003 and anticipates transmitting the FY 2003 audited financial statements to the Office of Management and Budget by December 19, 2003. Both the Department and the Inspector General have initiated joint planning tools and communication channels to better synchronize our efforts toward producing and auditing the financial statements. However, the impact of the accelerated reporting deadline has vividly emphasized the already evident need for systems that can produce reliable information on a real time basis.

One new challenge specific to FY 2003 is the requirement to report Military Equipment on the primary financial statements. In 1998, the Federal Accounting Standards Advisory Board directed that all military equipment be removed from the Department's Balance Sheet. Under a new accounting standard issued by the Federal Accounting Standards Advisory Board, the Department now must value and report Military Equipment as property on the Balance Sheet. The Department of Defense has struggled with developing policy and processes to track and value this equipment;

however, Military Equipment represents a significant portion of assets on the Balance Sheet. The Department currently estimates that more than \$1.1 trillion (less depreciation) will need to be added to the FY 2003 financial statements. Therefore, DoD will need to emphasize, as a priority, the development and implementation of a robust framework for tracking and valuing Military Equipment as it returns to the Department's financial statements.

During the past 5 years, we have issued more than 115 financial audit reports with almost 600 recommendations. About one-third of these recommendations are still open while management completes corrective action. These recommendations have covered a large number of problems relating to systems and process and control weaknesses within the Defense Finance and Accounting Service, the Military Departments, and various Defense agencies.

Strategy for Audited Financial Statements.

The financial reporting process will be significantly impacted by accelerated reporting requirements directed by the Office of Management and Budget, by the Department's energetic effort to overhaul its systems and business processes, and by the significant efforts made by the Under Secretary of Defense (Comptroller) and his staff to fully engage all parties including the Office of Management and Budget, the General Accounting Office, and the Office of the Inspector General in full and open dialogue on the Department's problems in achieving a favorable audit opinion.

This Winter, the Honorable David Walker, Comptroller General of the United States; the Honorable Mark Everson, then Deputy Director for Management of the Office of Management and Budget; the Honorable Dov Zakheim, Under Secretary of Defense

(Comptroller); and the Honorable Joseph Schmitz, Inspector General of the Department of Defense, all met to jointly agree on a strategy to accelerate the financial management improvement efforts in the Department. This cooperative effort is unprecedented in the history of the Department.

I would like to mention that the Under Secretary of Defense (Comptroller), as the Department's Chief Financial Officer, and his staff have a refreshing and unique open door policy to the Office of the Inspector General. The Office of the Inspector General, along with the Under Secretary of Defense (Comptroller), realize that the lack of a favorable opinion on the Department of Defense financial statements is a major impediment to the U.S. Government receiving an unqualified opinion on its annual financial statements. Without compromising our status as the independent auditor, the Inspector General, at the request of the Under Secretary of Defense (Comptroller), is actively participating in discussions with senior leadership within the Department and within the Government on ways to help the Department achieve a favorable audit opinion. Additionally, we now participate in joint quarterly reviews of the Department's financial statements with the Under Secretary of Defense (Comptroller) and senior financial managers of the Military Departments to identify material issues that impact the quality of the Department's financial reporting process.

The Inspector General has recently reorganized our financial auditing operations in order to better facilitate the increased emphasis on financial auditing and achieving favorable opinions on the various financial statements within the Department. The need to increase the level of professionalism of the audit staff was recognized and steps were initiated to encourage and fund the achievement of professional certifications and

advanced degrees. In addition, we are able to rapidly change priorities and audit efforts in order to respond to management assertions that financial data is ready for audit. For example, last year the U.S. Army Corps of Engineers provided us with a management representation that their Civil Works financial statements were reliable, fairly stated, and ready for audit. In support of the request, we quickly responded to the challenge by suspending numerous on-going projects and assigning 120 auditors (the majority of my staff) to verify the validity of management's representation.

For budgetary purposes, we recently analyzed the size, scope, and potential costs of comprehensive audits of Department of Defense financial statements when the Department represents that the statements are reliable. We considered various mixes of Government and public accounting resources. The Office of the Under Secretary of Defense (Comptroller) is currently evaluating this information, and conclusions have not been finalized.

Concurrent with our development of a long-term audit strategy, in February 2003, the Under Secretary of Defense (Comptroller) requested the Military Departments and the Defense Logistics Agency to develop an estimate of resources required to correct existing deficiencies in order to achieve a qualified audit opinion (rather than a disclaimer opinion) of the FY 2004 financial statements. Prior to the request, only the Army had prepared a long-term strategic plan to correct impediments to achieving a favorable opinion. The Army refined its plan and the other components prepared plans showing that, because of existing system deficiencies, large amounts of human and financial capital would be needed to ensure accounting records would be in a condition for a comprehensive audit of the FY 2004 financial statements. The plans generally conclude

that it is neither cost-effective nor practical to invest the resources necessary to obtain a favorable audit opinion by FY 2004. We are evaluating the results of these plans, and we generally accept their conclusions that it may be impractical to expect a favorable audit opinion on the FY 2004 financial statements of the major Department of Defense components. However, these plans are beneficial because they identify problems that need to be corrected, and will aid the Department in developing a methodical rationale for investing resources to correct the identified problems. The Under Secretary of Defense (Comptroller) and our office plan to develop a coordinated approach to addressing the challenges that impede an audit of the Department's financial statements.

These studies by the Military Departments and our estimates of the resources required for comprehensive audits of the financial statements for Department of Defense components have highlighted the challenges that we all face, and have given a new sense of urgency to solving long-standing financial accounting problems within the Department. We believe that these plans will provide a critical road map towards improvement and a means for measuring progress. However, regardless of the approach, we will need additional audit resources as the Department begins to improve its systems and processes and certifies that various financial statement line items and Components are ready for comprehensive audits.

Conclusion

As part of the effort to move forward and improve those systems and business processes, the Department's leadership has provided increased access and cooperation to

the Office of the Inspector General during the financial statement preparation and audit process. We especially want to thank the Under Secretary of Defense (Comptroller) and his staff for their relentless pursuit of the strategies needed to expedite the correction of long-standing problems preventing the Department from receiving a favorable audit opinion. This strong leadership is the key element to successful financial management reform. Our only concern is whether the Department's commitment can be sustained over the long road to successful completion of the numerous ongoing initiatives.

We are now fully committed to meet the challenges ahead. The Department must continue to improve its systems, processes, and internal controls necessary to ensure that financial information is accurately recorded and reported.

Thank you for considering the views of the Office of the Inspector General on financial management within the Department of Defense. This concludes my testimony.

ATTACHMENT 1

Required Financial Statement Audits. The Chief Financial Officers Act, the Government Management Reform Act Public Law 103-356, and Office of Management and Budget Bulletin 01-09, “Form and Content of Agency Financial Statements,” require the Department of Defense and 23 other Federal agencies to prepare agency-wide financial statements in accordance with Generally Accepted Accounting Principles. The financial statements must cover all accounts and associated activities of each agency. The Department of Defense Agency-wide financial statements provide the financial status of the entire Department. Within the Department, there are ten OMB required reporting entities that, while included in the Department of Defense Agency-wide statements, prepare separate stand-alone financial statements.

FY 2003 Reporting Requirements

REPORTING ENTITIES	NUMBER OF STATEMENTS
Agency –Wide	6
Army General Fund	5
Army Working Capital Fund	5
Navy General Fund	5
Navy Working Capital Fund	5
Air Force General Fund	5
Air Force Working Capital Fund	5
Military Retirement Fund	5
U.S. Army Corps of Engineers, Civil Works	5
Medicare Eligible Retiree Health Care Fund*	5
<u>TOTAL REQUIRED BY OMB</u>	51
National Security Agency**	5
Defense Intelligence Agency**	5
National Imagery and Mapping Agency**	5
<u>Total</u>	66

* New Reporting Requirement effective in FY 2003

** The Senate Select Committee on Intelligence in Committee Report 107-63 directed audits of the form and content of the financial statements. The Committee further directed that these intelligence agencies receive an annual audit of their financial statements beginning in FY 2004.

Each reporting entity prepares the following five financial statements.

- Balance Sheet
- Statement of Budgetary Resources
- Statement of Net Cost
- Statement of Changes in Net Position
- Statement of Financing

The annual financial statements also include an Overview, Notes to the Principal Statements, and Required Supplemental and Other Accompanying Information, as appropriate.

In addition to the reporting entities required by the Office of Management and Budget shown in the table above, the remaining accounts of the Department are reported in two columns of the consolidating balance sheet for the Department of Defense Agency-wide financial statements. The two columns present the accounts of:

Other Defense Organizations-General Fund
Other Defense Organizations-Working Capital Fund

Included in the Other Defense Organizations are approximately 38 Defense agencies, field activities, trust funds, and other funds administered by the Office of the Secretary of Defense. The Under Secretary of Defense (Comptroller) requires an additional nine of these Other Defense Organizations to prepare stand-alone financial statements:

- Defense Advanced Research Projects Agency
- Defense Commissary Agency
- Defense Contract Audit Agency
- Defense Finance and Accounting Service
- Defense Information Systems Agency
- Defense Logistics Agency
- Defense Security Service
- Defense Threat Reduction Agency
- Missile Defense Agency

Statement of Custodial Activity. The DoD Agency-wide financial statements also include a Statement of Custodial Activity that includes deposits by foreign governments and disbursements in their behalf.

Attachment 2

Audit Reports		
Report Number	Report Title	Report Date
D-2003-091 (Secret)	“Reliability of the FY 2002 National Security Agency Financial Statements and Adequacy of Related Procedures and Control”	May 14, 2003
D-2003-074 (Secret)	“Reliability of the FY 2002 Defense Intelligence Agency Financial Statements and Adequacy of Related Procedures and Control”	April 7, 2003
D-2003-073 (Secret)	“Reliability of the FY 2002 National Imagery and Mapping Agency Financial Statements and Adequacy of Related Procedures and Control”	April 2, 2003
D-2003-067	“Audit of Recoveries of Prior-Year Obligations”	March 21, 2003
D-2003-058	“Financial Reporting of Deferred Maintenance Information on Navy Weapon Systems for FY 2002”	March 6, 2003
D-2003-054	“Financial Reporting of Deferred Maintenance Information on Army Weapons Systems for FY 2002”	February 3, 2003
D-2003-050	“Independent Auditor's Report on the Department of Defense Fiscal Year 2002 Agency-Wide Principal Financial Statements”	January 15, 2003
D-2003-047	“Independent Auditor's Report on the Army General Fund Fiscal Year 2002 Principal Financial Statements”	January 8, 2003
D-2003-046	“Independent Auditor's Report on the Army Working Capital Fund Fiscal Year 2002 Principal Financial Statements”	January 8, 2003
D-2003-045	“Independent Auditor's Report on the Department of the Navy Working Capital Fund Fiscal Year 2002 Principal Financial Statements”	January 7, 2003

D-2003-044	“Independent Auditor's Report on the Navy General Fund Fiscal Year 2002 Principal Financial Statements”	January 7, 2003
D-2003-043	“Independent Auditor's Report on the U.S. Army Corps of Engineers, Civil Works, Fiscal Year 2002 Principal Financial Statements”	January 6, 2003
D-2003-042	“Independent Auditor's Report on the Air Force Working Capital Fund Fiscal Year 2002 Principal Financial Statements”	January 6, 2003
D-2003-041	“Independent Auditor's Report on the Air Force General Funds Fiscal Year 2002 Principal Financial Statements”	January 6, 2003
D-2003-039	“Naval Supply Systems Command Revaluation of Inventory to Latest Acquisition Cost”	December 31, 2002
D-2003-035 (FOUO)	“The Integrated Automated Travel System Information Security Program”	December 16, 2002
D-2003-030	“Financial Reporting of Deferred Maintenance Information on Air Force Weapons Systems for FY 2002”	November 27, 2002
D-2003-020	“Naval Air Systems Command Financial Reporting of Non-Ammunition Operating Material and Supplies for FY 2002”	November 8, 2002
D-2002-076	“Funding Invoices to Expedite the Closure of Contracts Before Transitioning to a New DoD Payment System”	March 29, 2002