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Statement
of
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before the

Subcommittee on Federal Financial Management,
Government Information and International Security
Senate Committee on Homeland Security and
Governmental Affairs

on

"Financial Management at the Department of Defense"

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to discuss, first, the financial management challenges that the Department of Defense continues to face; and second, the progress that the Department has made in addressing the challenges and achieving the goals established in the 2001 Quadrennial Defense Review (QDR).

The Department's financial statements are the most extensive, complex, and diverse financial statements in the Government. As we reported in prior testimony,[1] the Department faces financial management problems that are long standing, pervasive, and deeply rooted in virtually all operations. Those financial management problems continue to impede the Department's ability to provide reliable, timely, and useful financial and managerial data to support operating, budgeting, and policy decisions. The problems have also prevented the Department from receiving an unqualified opinion on its financial statements.

We are encouraged, however, by the framework the Department has established to address those problems. This framework can provide direction to the Department's financial improvement efforts and can be the mechanism for holding the Department's managers accountable for correcting specific weaknesses and for meeting milestones. More importantly, it provides a mechanism for measuring success.

The challenge to Department managers is to continue to fortify and refine the framework. However, they also must maintain a sustained effort and focus within the framework to identify, monitor and correct internal control and systems weaknesses. The Department's financial improvement effort must be focused on implementing the corrective actions needed throughout the Department to improve financial management. Ongoing Office of Inspector General audit work is described in the Attachment.

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[1] Department of Defense Office of the Inspector General Report Number D-2004-105-T, "Statement of Francis E. Reardon, Deputy Inspector General for Auditing Office of the Inspector General Department of Defense before the subcommittee on Financial Management, the Budget and International Security Senate Committee on Governmental Affairs on 'Department of Defense FY 2003 Financial Statements'" July 8, 2004.

Opinions on Financial Statements for FY 2005

The Fiscal Year 2005, DoD Agency-Wide Principal Financial Statements reported $1.3 trillion in assets, $1.9 trillion in liabilities, and $635 billion in Net Cost of Operations. We issued a disclaimer of opinion for the statements because numerous deficiencies continue to exist related to the quality of data, adequacy of reporting systems, and reliability of internal controls.

Nine DoD Components are required by the Office of Management and Budget (OMB) to prepare and obtain an audit opinion on their FY 2005 financial statements. Only the Military Retirement Fund received an unqualified opinion. The Medicare-Eligible Health Care Fund received a qualified opinion. All the others, including the agency-wide financial statements, received a disclaimer of opinion, as they have every year in the past.

DoD's financial management problems are so significant that they constitute the single largest and most challenging impediment to the U.S Government's ability to obtain an opinion on its consolidated financial statements. In its March 3, 2006, Executive Branch Management Scorecard, OMB assessed the status of the department's financial performance as "Red," or "Unsatisfactory." The weaknesses that affect the auditability of the financial statements also impact other DoD programs and operations and contribute to waste, mismanagement, and inefficient use of DoD resources. These weaknesses affect the safeguarding of assets and proper use of funds and impair the prevention and identification of fraud, waste, and abuse.

Internal Control Deficiencies

Issues of reliability, integrity, timeliness, and auditability of financial data continue to impede our ability to render an opinion on the financial statements. We have reported those weaknesses to the Department and have also made recommendations to correct those weaknesses. The Department's progress in addressing the specific findings and recommendations made in individual audit reports will be a critical factor in determining how much financial management improvement occurs. We have identified reportable conditions in Accounts Payable, Accounts Receivable, and Contingent Legal Liabilities.

We also have identified the following list of current material internal control weaknesses.

1. Financial Management Systems
2. Fund Balance with Treasury
3. Inventory
4. Operating Materials and Supplies
5. Property, Plant and Equipment
6. Government-Furnished Material and Contractor-Acquired Material
7. Environmental Liabilities
8. Intragovernmental Eliminations
9. Accounting Entries
10. Statement of Net Cost
11. Statement of Financing

These weaknesses affect the quality of the data that DoD managers at all levels use and rely on for decision-making. Poor data quality impairs management's ability to: make informed decisions, manage programs and funds efficiently, effectively meet objectives, comply with laws and statutory and regulatory requirements, and provide sufficient and timely support to the warfighter.

DoD management has acknowledged these financial weaknesses. However, DoD financial management is decentralized. The Under Secretary of Defense (Comptroller)/Chief Financial Officer has overall responsibility for financial management. However, the Assistant Secretaries of the various Military Departments (Financial Management and Comptroller) and the Chief Financial Executives (or other named positions) have the primary responsibility within their Components. Thus, it is difficult for the Department to oversee the implementation of DoD OIG recommendations for corrective action.

The DoD OIG makes recommendations to the lowest level of management that has the authority or ability to perform the corrective action. Normally this level of authority resides in the Commander, Director, or the Under Secretary- or Assistant Secretary-level rather than the actual Division or Directorate which would implement the recommendation. We make a great number of recommendations to the Defense Finance and Accounting Service because they own most of the major financial accounting and management systems within DoD; however, we make recommendations to the Under Secretary of Defense (Comptroller)/Chief Financial Officer when policy issues need to be addressed or we see a need for DoD-Wide actions guided by top management. The DoD OIG performs follow-up procedures to determine whether management accepts and implements our recommendations.

Challenges

In the past, DoD did not have a specific, coordinated organizational structure or plan to identify, coordinate, and monitor the corrective actions and key milestone dates for the previously identified financial management weaknesses. Additionally, DoD did not have a structure to identify additional weaknesses or hold managers accountable for implementing corrective actions and meeting key milestones. These elements are fundamental to successfully implementing financial management improvements in an organization as complex and decentralized as DoD. Specifically, the following elements and actions are key to improving the Department's financial management.

- **Create** an environment that fully supports clean financial reporting. The financial managers need buy-in from senior management and personnel in the field offices in order to successfully implement the corrective action plans.
- Maintain a significant level of continued review to **identify** all of the material financial management and reporting deficiencies, internal control weaknesses, and quality of data issues.
- **Develop** corrective action plans that will adequately correct the deficiencies and result in financial reporting in accordance with generally accepted accounting principles (GAAP).

- **Implement** the corrective action plans that address the system, control, reporting, or quality of data weakness.

The most significant financial management challenge facing the Department is the ability of the individual DoD financial managers to sustain their focus and efforts on those key elements. However, they must successfully implement all four elements because eliminating even one poses a significant risk that DoD will not achieve improved financial management processes and systems and earn favorable audit results.

Another significant financial management challenge for the Department is unreliable financial data from legacy systems. Unless the data's completeness and accuracy are properly verified before being carried forward to the new systems, the data will continue to be unreliable and may contaminate summary data in future enterprise systems.

Progress

The Department's overall business systems modernization effort encompasses all facets of DoD operations, including the area of financial management. Specifically, in that area, the Department has made progress by establishing a framework to direct and hold managers accountable for the Department's financial improvement efforts. The framework, called the Financial Improvement and Audit Readiness (FIAR) improvement initiative, comprises a directorate that is responsible for centrally coordinating the initiative; a regularly updated, written plan with stated objectives and milestones; a defined process with protocols for making decisions; a tool for tracking progress; and oversight groups consisting of participants from across DoD to guide the decision making process.

The Department's financial managers are developing and updating corrective action plans in the FIAR plan, refining the Department's roadmap to correct deficiencies and achieve proper financial reporting. Success of the FIAR plan rests with each financial manager's efforts to identify all major financial management problems, and develop corresponding action plans, and fully implement the corrective actions. Failure on the part of the

financial managers to succeed in any of these elements will prevent the respective reporting entity from achieving favorable audit results.

The FIAR plan categorizes the financial management challenges faced by the Department into three broad categories: those that heavily depend on systems solutions; those that depend primarily on process solutions; and those that depend on both systems and process solutions. The FIAR plan focuses on the process solutions that DoD financial managers identify, develop, and implement to correct financial reporting deficiencies or internal control weaknesses. The DoD OIG has primarily focused its audit efforts on the FIAR improvement initiative.

On the other hand, the Enterprise Transition Plan (ETP) addresses systems solutions. The September 2001 QDR reported that one element of the Department's goal to "Revitalizing the DoD Establishment" is to "Modernize the DoD-wide approach to business information." In that section, the Departments stated that:

> DoD will create a Department-wide blueprint (enterprise architecture) that will prescribe how the Department's financial and non-financial feeder systems and management processes will interact. This architecture will guide the development of enterprise-level processes and systems throughout DoD.

The Department has made progress toward achieving that goal by establishing the Business Transformation Agency and developing the business enterprise architecture and the Enterprise Transition Plan. The Government Accountability Office (GAO) has been fully engaged in auditing the Enterprise Transition Plan. GAO's most recent report "Business Systems Modernization: DoD Continues to Improve Institutional Approach, but Further Steps Needed," (Report No. GAO-06-658) May 2006, discusses the additional steps the Department should take in the Enterprise Transition Plan.

Since the 2001 QDR, the Department has spent funds on the systems infrastructure relating to the Enterprise Transition Plan. According to the GAO report just cited, the

Department will receive approximately $15.5 billion in FY 2006, and requested $16 billion for FY 2007, to operate, maintain, and modernize its business systems.

Successes

In the area of financial management, the DoD OIG considers the following DoD financial management efforts to be successes: implementation of integrated organizational structures and processes to address financial management improvement, assignment of accountability to DoD managers, DoD improvement initiatives at the entity and line item level, and self assessment of controls over financial reporting related to OMB Circular A-123. Although the DoD OIG anticipates that DoD will need to make refinements in these areas, the DoD OIG considers these to be critical steps in establishing a culture/ingrained structure that will enable DoD managers to identify internal control weaknesses and effectively plan for resolution of those weaknesses and that will hold DoD managers accountable for improving internal controls over financial reporting. Further, these steps should result in a financial management structure that can provide accurate, relevant, and timely financial management information for decision-making.

We fully support the Department's goal to implement internal controls that will result in sustained improvements in its ability to produce timely, reliable, and complete financial management information. To that end, DoD needs to continue the development of comprehensive, integrated plans that will lead to improved systems and internal control. We are quick to add that we recognize that there are many variables affecting the execution of DoD improvement initiatives, such as specific Components' ability to make corrective actions and meet the projected milestones. The DoD OIG will continue to provide input to the DoD managers on these initiatives as requested, or as part of the DoD OIG's advisory role on the DoD committees that support these initiatives.

Organizational Structure and Processes. DoD established the FIAR Directorate of the Office of the Under Secretary of Defense (Comptroller) to manage the DoD-wide financial management improvement efforts and to integrate those efforts with transformation activities across DoD. The FIAR Directorate is also responsible for the development and update of the FIAR Plan which establishes a DoD-wide strategy and

systematic, incremental approach for improving financial and business operations. The FIAR Plan prioritizes DoD financial improvement efforts and is fully integrated with the ETP initiative that is being coordinated by the Business Transformation Agency. As part of the FIAR initiative, DoD formed an Executive Steering Committee (ESC) to provide oversight, and established the FIAR Committee, FIAR Subcommittee, and Senior Assessment Team (SAT) to provide leadership for developing the structure and priorities of the FIAR planning process. The FIAR Committee also develops strategies and plans for expanding, managing, and overseeing the FIAR Plan and oversees the process for management's assertion on internal control over financial reporting. The DoD OIG acts as an advisor to the ESC, FIAR Committee and SAT.

In addition to the organizational structure, the Under Secretary of Defense (Comptroller) designed the FIAR Plan and business rules to provide an organized process for examining its operations, diagnosing problems, planning corrective actions, and preparing for audit. The FIAR Plan identifies focus areas for improvement and the key milestone plans for taking corrective actions and eventually achieving auditable areas. The business rules outline five standard steps[2] that each Component must follow when planning financial management improvements.

Accountability. DoD has taken steps to make accountability an important component of the DoD financial improvement initiatives. Under the FIAR improvement initiative, DoD managers are assigned responsibility for specific corrective actions and senior DoD leaders monitor progress regularly to determine whether projected milestones are met. Specifically, the Deputy Chief Financial Officer reviews the status of the FIAR Plan Priorities monthly and the Under Secretary of Defense (Comptroller)/Chief Financial Officer conducts quarterly reviews that require the Military Department Assistant Secretaries for Financial Management/Comptroller and the Assistant Deputy for Programs and Resources of the U.S. Marine Corps to present their overall progress, issues, and accomplishments.

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[2] The five steps are: discovery and correction; validation; assertion; assessment; and audit. The steps are discussed in detail on pages 10 and 11 of the December 2005 Defense Financial Improvement and Audit Readiness Plan.

Improvement Initiatives. DoD has implemented improvement initiatives at the DoD level and at the entity and line item level. The FIAR Plan identifies the following focus areas for improvement: Military Equipment, Real Property, Medicare-Eligible Retiree Health Care Fund, and Environmental Liabilities. Additionally, individual DoD entities, such as USACE, have implemented financial improvement initiatives. Since FY 2000, DoD OIG, U.S. Government Accountability Office, and Army Audit Agency have issued numerous reports discussing deficiencies related to the U.S. Army Corps of Engineers (USACE) balance sheet.

In October 2004, DoD OIG announced an audit to determine the progress USACE made in taking corrective actions that were recommended in previous audit reports. Based on the DoD OIG audit work, USACE conducted a workshop in May 2005 to discuss a "Get Well" plan and continued to take corrective actions. As a result of those efforts, the USACE asserted that their financial statements were ready for audit and the Executive Steering Committee, which includes representatives from OSD and DOD OIG, approved the audit in March 2006. The contract for audit was awarded in April 2006. The audit work began in May 2006 and the audit report should be completed in November 2006. The DoD OIG is providing oversight of those audit efforts.

The Air Force implemented a financial improvement initiative over Fund Balance With Treasury and asserted that the line item was ready for audit. It is now in the process of awarding a contract. The Air Force has also asserted that cash and other monetary assets is ready for audit.

Self Assessment. Another important step to success in financial management is DoD's implementation of OMB Circular A-123 Revised, "Management's Responsibility for Internal Control, Appendix A: Internal Control Over Financial Reporting," December 21, 2004. The requirements of OMB Circular A-123 Revised were effective beginning with Fiscal Year 2006. Under the new requirements included in Appendix A, managers must assess, document, test, and report on the effectiveness of internal controls over financial reporting. Appendix A also requires an annual report, which DoD will publish in the DoD Performance and Accountability Report.

In response to the new Appendix A requirements, DoD established written guidelines and processes for assessing internal control over financial reporting. DoD included the requirements for assessing internal control over financial reporting in the DoD "Fiscal Year (FY) 2006 Guidance for the Preparation of the Statement of Assurance," November 8, 2005. DoD plans an incremental approach to assessing internal controls over financial reporting, which has been approved by OMB. For FY 2006, the DoD plan included 31 financial reporting entities and 8 focus areas (Fund Balance with Treasury, Investments, Real Property, Military Equipment, Federal Employment Compensation Act (FECA) Liability, Environmental Liabilities, Health Care, and Appropriations Received). DoD also established a Senior Assessment Team to provide oversight and guidance to the managers that will be performing the assessments.

This new requirement for managers to perform a self assessment of the controls over financial reporting and provide assurance on the effectiveness of those controls should go a long way in establishing an ongoing formal process by which managers will identify control weaknesses, identify corrective actions and milestones, and be held accountable for resolution of those weaknesses. This formalized process should result in DoD managers focusing on the identification and resolution of financial related internal control weaknesses which will lead to improved accountability and reporting within DoD.

Conclusion

The Department must recognize that financial improvement is an ongoing effort that needs sustained management attention and accountability at all levels. In order for the Department to achieve results in the financial management area, the Department must exercise rigor and continued management focus in executing the Enterprise Transition Plan, FIAR plan, and assessments of internal controls over financial reporting under OMB A-123. Not only does the Department need to focus financial management improvement efforts on the known deficiencies, but it also needs to continue developing corrective action plans for financial management challenges identified during the course of business and while implementing the programs discussed above.

The FIAR plan is the Department's roadmap to correct deficiencies and achieve proper financial reporting. The known deficiencies include: financial management systems; fund balance with Treasury; inventory; operating materials and supplies; property, plant, and equipment; government-furnished material and contractor-acquired material; environmental liabilities; intragovernmental eliminations; accounting entries; accounts payable; accounts receivable; Statement of Net Cost; and Statement of Financing. In addition, we believe that the quality of existing financial data is a major challenge that the Department faces.

The Department's financial managers have to scrub their financial reporting processes to ensure that they have identified all of the major deficiencies and internal control weaknesses in order to achieve financial reporting success. Although the Department has some successes in establishing the framework to execute financial improvement and audit readiness initiatives, continued focus and commitment by management are needed to successfully execute the financial improvement initiative. Management must continue to execute the initiative with rigor and aggressively take steps to identify and correct the pervasive weaknesses that have impaired the Department's ability to achieve auditable financial statements, and more importantly, to provide reliable, accurate and timely data for decision making.

ATTACHMENT

Summary of Other DoD OIG Work

Overview of Financial Management Work

The following is a summary of the work the DoD OIG has done in the financial management area:

- CFO Act Audits - We issued disclaimer opinion reports, and related reports on internal control and compliance with laws and regulations, on the FY 2005 DoD Agency-Wide Financial Statements and seven other Component financial statements whose audits are required by OMB. In addition, DoD OIG issued an unqualified opinion on the FY 2005 Military Retirement Fund financial statements and a qualified opinion on the FY 2005 Medicare-Eligible Retiree Health Care Fund financial statements. The DoD OIG cited the following material internal control weaknesses in the DoD Agency-wide report: financial management systems; fund balance with Treasury; inventory; operating materials and supplies; property, plant, and equipment; government-furnished material and contractor-acquired material; environmental liabilities; intragovernmental eliminations; accounting entries; Statement of Net Cost; and Statement of Financing. DoD OIG also issued reports on the FY 2005 DoD Agency-wide special purpose financial statements and the FY 2005 intragovernmental agreed-upon procedures required by OMB.

- Line-item work - We have audit teams dedicated to the following material line items on the DoD Agency-Wide balance sheet: Fund Balance with Treasury; General Property, Plant, and Equipment; Military Equipment; Inventory; Operation Materials and Supplies; Environmental Liabilities; and Accounts Payable. These teams are subject matter experts and track the Department's progress of correcting deficiencies. They are responsible for the audit and attestation work performed on these line items.

- Information Systems Audits - The DoD OIG performed six Statements on Auditing Standards 70/88 audits of DoD systems in FY 2005 and plan to audit additional systems in FY 2006. In performing our examinations, we test the design and operating effectiveness of the controls in operation. In FY 2005, we found that the controls in place to ensure compliance with DoD information assurance policies appeared to be suitably designed, but our tests of the design and operating effectiveness indicated inconsistencies in the adherence to DoD policies. Specifically, we found design control weaknesses regarding access controls in the areas of user and access rights, physical and logical controls to detect unauthorized access, and audit trails. Additionally, tests of operating effectiveness identified primary deficiencies in authorization, completeness, change controls, and configuration management.

- Compliance Audits - In addition to the compliance work we perform during our annual financial statement audits of DoD agency-wide and Component financial statements, we perform several stand-alone compliance audits. In FY 2006, we are auditing the Department's compliance with the Federal Manager's Financial Integrity Act, Prompt Pay Act, Antideficiency Act, Government Performance and Results Act, and the Improper Payment Act.

- Intelligence Agency Financial Statement Audits - The Senate Select Committee on Intelligence currently requires audit opinions on the FY 2007 Defense Intelligence Agency, National Security Agency, and National Geospatial-Intelligence Agency financial statements. In anticipation of this requirement, during the past several years, we have conducted and are continuing to perform financial-related audits on the financial data and operations of these intelligence agencies.

- Other - The DoD OIG Data Mining Directorate, DFAS, and the DCIS have teamed together to identify DoD freight transportation payment systems that are vulnerable to fraud and other abuse. PowerTrack, an Internet-based freight payment system, is the DoD's primary method for paying for freight transportation and has streamlined the payment process by electronically allowing carriers to bill shippers for payment. DoD OIG health care audit resources focused on an audit of controls over payments made to overseas health care providers. Additionally the DoD OIG initiated an audit of the Third Party Collection Program to evaluate the implementation of itemized outpatient billing.

Current Audit Projects

We are currently working on a number of audit projects that should provide assessments, conclusions and recommendations related to financial management within DoD. For example:

- Financial Management of supplemental funds and relief efforts related to Hurricane Katrina.

- Several audits related to DoD Components' management of funds on outgoing and incoming military interdepartmental purchase requests (MIPRs) (to include organizations such as Defense Intelligence Agency, National Geospatial-Intelligence Agency, Marine Corps, Army, Missile Defense Agency, U.S. Special Operations Command).

- Controls over identifying, disclosing, and correcting abnormal balances and compilation of the financial statements for Other Defense Organizations.

- Several audits of DoD systems to determine their compliance with financial accounting requirements and other internal control and regulatory

requirements. (Systems include Integrated Accounts Payable System, DFAS Corporate Database/Warehouse, Army Corps of Engineers Financial Management System, Defense Travel System, Defense Civilian Pay System, Military Sealift Command Financial Management System , Army General Fund Enterprise Business System,

- DoD Compliance with the Federal Managers' Financial Integrity Act of 1982
- DoD Garnishment Program
- Internal Controls and Management of Purchase Card Program
- Controls Over Prevalidation of DoD Commercial Payments
- Military Pay Accounting Operations & Controls Over Air Force Military Pay and Allowances
- Internal Controls Over Inventory Stored at DLA Distribution Depots
- Controls Over Army Cash and other Monetary Assets.
- Budget Execution Operations at DFAS
- Air Force Vendor Pay Disbursement Cycle
- Processes and Procedures for Recognizing and Reporting Accounts Payable.
- Agreed-Upon Procedures on the Air Force General Fund Balance with Treasury Line Item.
- Limited Scope Audits to Provide a Disclaimer Opinion on the Following FY 2006 Financial Statements: DoD-Wide; and Army, Navy and Air Force General and Working Capital Funds.
- Full Scope Audits to Provide an Opinion on the Following FY 2006 Financial Statements: Military Retirement Fund, Medicare Eligible Retiree Health Care Fund, and Army Corps of Engineers.

Planned Audit Projects

In addition to on-going audits, we have several additional audits planned during the next 12 to 15 months. For example:

- Financial Management of International Military Educational Training Funds

- Audits of Defense Intelligence Agencies' Financial Statements as Required by the Senate Select Committee on Intelligence
- Identification and Reporting of Improper Payments in DoD
- Military Personnel Receiving Housing Allowances
- DoD Emergency Response Fund
- DoD Purchases through the Veteran's Administration
- Air Force Fund Balance With Treasury, Cash and Other Monetary Assets
- Reliability of Contingent Liabilities for the Defense Logistics Agency
- Several audits of DoD Systems to Determine Their Compliance with Financial Accounting Requirements and Other Internal Control and Regulatory Requirements (Standard Accounting and Reporting System,
- FY 2006 Obligations for the DoD Counterdrug Program
- Controls Over Out of Country Payments
- Financial Reporting for Nonappropriated Funds