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**DEPARTMENT OF
DEFENSE**

**Status of Financial
Management Weaknesses
and Actions Needed to
Correct Continuing
Challenges**

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Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss the status of financial management at the Department of Defense (DOD). This discussion is particularly timely in light of our recent report¹ on the fiscal year 1998 Financial Report of the U.S. Government. Material financial management deficiencies identified at DOD, taken together, represent the single largest obstacle that must be effectively addressed to achieve an unqualified opinion on the U.S. government's consolidated financial statements. DOD's vast operations—with an estimated \$1 trillion in assets, nearly \$1 trillion in liabilities, and a net cost of operations of \$280 billion in fiscal year 1998—have a tremendous impact on the government's consolidated reporting.

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

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

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

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

No major part of DOD has been able to pass the test of an independent audit; auditors consistently have issued disclaimers of opinion because of pervasive weaknesses in DOD's financial management operations. Such problems led us in 1995 to put DOD financial management on our list of high-risk areas vulnerable to waste, fraud, abuse, and mismanagement, a designation that continued in our recent high-risk update.² The audits of DOD's and individual military services' financial statements for fiscal year 1998 performed by the DOD Inspector General (IG) and the military service audit agencies, as well as our audit of the U.S. government's financial statements, have provided further clarification of the scope and magnitude of the department's problems, and recommendations to correct them.

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

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

²High-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).

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

Control and Accountability Over Assets Impaired

As discussed in our recent report on the fiscal year 1998 consolidated financial statements, the federal government—one of the world's largest holders of physical assets—does not have accurate information about the amount of assets held to support its domestic and global operations. DOD primarily relies on various logistical systems to carry out its important stewardship responsibility over an estimated \$1 trillion in physical assets, ranging from enormous inventories of ammunition, stockpile materials, and other military items to buildings and facilities to multimillion dollar weapon systems. These logistics systems are the primary source of information for (1) maintaining visibility over assets to meet military objectives and readiness goals and (2) financial reporting. However, as we testified last year,³ these systems have material weaknesses that, in addition to hampering central visibility and financial reporting, impair DOD's ability to safeguard those assets from physical deterioration, theft, or loss or to prevent the purchase of assets already on hand in sufficient quantities.

Overall, these weaknesses can seriously diminish the efficiency and economy of the military services' support operations. For example, as noted in our recent report,⁴ DOD's lessons-learned studies from Operation Desert Storm found that better asset tracking could have saved \$2 billion. In response to this problem, the department initiated programs or renewed its emphasis on implementing existing measures that would improve asset visibility and tracking. The Global Combat Support System (GCSS), led by the Defense Information Systems Agency, was established in September 1995 to 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

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

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

units, personnel, equipment, and supplies—including weapon systems, secondary inventory,⁵ and ammunition. The effectiveness of these programs in achieving their common objectives of supporting the warfighter will depend on the accuracy and timeliness of information provided by the underlying systems.

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

Continuing Control Weaknesses Over Inventory

As part of the fiscal year 1998 financial statement audits, auditors continued to find that DOD's inventory management and control systems and practices are plagued with serious problems that affect its ability to maintain accurate and complete inventory data. DOD inventory⁶ includes ammunition (such as machine gun cartridges, rocket motors, and grenades), repairable items (such as navigational computers, landing gear, and hydraulic pumps), consumables (such as clothing, bolts, and medical supplies), and stockpile materials (such as industrial diamonds, rubber, and tungsten). DOD's inability to effectively account for and control its reported \$122 billion investment in inventories has been an ongoing area of major concern. Audit findings for fiscal year 1998 include problems in verifying inventory quantities and value, reporting all inventory, and accounting for in-transit inventory. The sheer volume of DOD's on-hand inventories also impedes the Department's efforts to accumulate and report accurate inventory data.

On-hand Quantities Not in Agreement With Records. The Defense Logistic Agency (DLA) distribution depots' inventory records, which account for approximately 75 percent of DOD's reported inventory, supply much of the information for management and financial reporting. Over the years, auditors have repeatedly found problems with the accuracy of DOD's perpetual inventory records, although recent improvements in reported

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

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

accuracy rates have been noted. For example, for 1996, the DOD IG reported a 24 percent error rate at DOD's primary storage locations⁷ and, for 1997, Navy auditors reported a 23 percent error rate for the 13 major storage locations they visited.⁸ For 1998, preliminary results from Navy auditors' tests showed an improved error rate of 14 percent for the 18 locations visited. Navy officials attributed much of the improvement in inventory record accuracy to extensive rewarehousing—a wall-to-wall physical inventory done to facilitate conversion to a new logistics system. However, preliminary results of tests we conducted for 1998, identified control weaknesses that indicate DOD's reported rates cannot be relied upon to provide a true measure of physical inventory accuracy.

As part of our audit effort for the fiscal year 1998 financial statements, we evaluated DOD procedures for verifying the accuracy of its perpetual inventory records and found significant weaknesses. We have provided our draft report on these issues to DOD officials for their review and comment prior to its release. Although DLA established a record accuracy goal of 95 percent for fiscal year 1998, we found that, at the 14 distributions depots we visited, reported accuracy rates fell below that goal. For fiscal year 1998 counts, only two depots had inventory accuracy rates above 90 percent. In addition, several significant control weaknesses in the inventory count process affected the integrity of the counts and these accuracy rates. For example, at all of the depots we visited, counters could access the inventory system to determine the expected number of inventory items on hand. At one depot, we observed counters obtaining system quantities for some of the sample items and recording these amounts as the physical count for the items. When we requested an actual physical count of these items, all had variances. One of the items—night image intensifiers, a controlled item⁹ commonly referred to as “night vision goggles” with a unit price of about \$1,300—had a variance of 1,018 items, which resulted in a \$1.3 million loss adjustment to the inventory records.

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

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

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

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

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

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

As a result, DOD developed an agencywide model in 1994 for the purpose of estimating historical cost for inventories. The valuation model uses general ledger data to adjust recorded inventory values to arrive at an estimate of historical costs and to calculate costs of goods sold. However,

due to concerns about the accuracy of general ledger data, and weak internal control over the development and operation of the valuation model, auditors have been unable to evaluate the effectiveness of the model, or the estimates of historical cost and cost of goods sold.

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

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

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

or obsolete. However, we have previously reported that in 1996 about 39 percent of DOD's total ammunition stockpile was excess and that about 27 percent was unserviceable.¹⁰

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

In-transit Inventories. The vulnerability of in-transit inventory to waste, fraud, and abuse is another area of concern. Similar to last year's results, auditors were not able to confirm the in-transit inventory, which is included in the reported overall inventory balance on hand. For example, auditors could not determine the reasonableness of almost \$600 million of the Army's reported inventory in-transit from procurement. In addition, preliminary audit results indicate that the Navy's reported in-transit

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

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

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

inventory differed from subsidiary records by about \$2 billion and that the Navy had not determined the cause for the difference between the detail records and the reported amount. We also recently testified on the Navy's problems with controlling in-transit items.¹³ Specifically, we reported that Navy activities were not adhering to control procedures to ensure that in-transit items are accounted for and that responsible commands had not been performing adequate oversight. As a result, the Navy wrote off as lost over \$3 billion of in-transit inventory over the last 3 years, including some classified and sensitive items such as aircraft guided-missile launchers, military night vision devices, and communications equipment. This lack of control leaves enormous amounts of inventory at risk of undetected theft or misplacement.

Excess Inventories. The sheer size and volume of DOD's on-hand inventories also impedes the Department's efforts to accumulate and report accurate inventory data. We reported in our January 1999 high-risk report on defense inventory management that the department needs to avoid burdening its supply system with large unneeded inventories.¹⁴ In April 1999, we reported¹⁵ that about 60 percent of on-hand items, or an estimated \$39.4 billion of DOD's reported secondary inventory, exceeded DOD's requirements. The DOD IG has also reported¹⁶ that about \$3 billion of DLA's reported \$9.8 billion of consumable inventory was inactive and of uncertain future utility. As a result, DOD is incurring unneeded inventory holding costs. In 1997, we estimated¹⁷ that the military services could save about \$382 million annually in inventory holding costs by eliminating inventory at nonmajor locations that is not needed to meet current requirements. DOD has also acknowledged the need to reduce its inventories and has established goals to reduce supply inventory by \$12 billion by 2000.

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

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

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

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

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

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

Unreliable Amounts Reported for General Property, Plant and Equipment

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

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

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

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

While evaluating the accuracy of assets included in DOD's real property databases, auditors also performed limited tests on whether all assets at DOD installations were included in the databases, i.e., whether the databases were complete. Auditors judgmentally selected assets on the installations and attempted to trace them to the real property databases. For example, at the 62 Army locations reviewed, 48 of 161 items selected were not recorded in the Army's real property databases. Most of the unrecorded assets were support facilities and included parking lots, fences, utilities, and storage sheds. In addition, when the Corps of Engineers converted to a new property accounting system this year, it did not transfer to the system approximately \$4 billion of assets.

Valuation of real property assets in the databases is perhaps the greatest hurdle the department must overcome. What the department paid for its assets is an important component of determining costs for operating its facilities. For fiscal year 1998, DOD auditors found numerous valuation

errors due to duplications, misclassifications, omissions, and lack of supporting documentation. Examples of audit finding of errors in reported values include

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

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

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

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

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

Capitalization Threshold Needs Evaluation. As we testified last year, DOD's ability to accurately report its property, plant and equipment values has

been further hampered by the 20-fold increase in its capitalization threshold from \$5,000 in 1991 to \$100,000 in 1996, and by the retroactive application of the \$100,000 threshold in 1998 to all DOD components, except working capital fund activities. As a result of the higher capitalization threshold, DOD has expensed billions of dollars of assets, which has effectively removed them from accounting control. These assets have useful lives of more than 2 years. For example, over 100,000 vehicles costing approximately \$2.6 billion that are held by the Army, Air Force, and Navy, do not meet the \$100,000 capitalization threshold. In addition, financial audits have repeatedly found that DOD's detailed property records are not accurate. For example, based on a statistical sample, Air Force auditors concluded that the Air Force's real property database did not provide accountability over assets valued at less than \$100,000.

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

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

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

DOD has also directed that its components have or expeditiously develop fully operational property accountability systems that meet federal accounting and systems requirements, including the capability to capture and maintain historical cost data and calculate depreciation for general

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

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

Accountability Lacking Over National Defense Assets

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

For fiscal year 1997, auditors performed specific tests to validate the data in the logistics systems reporting military equipment. Because of the sensitive nature of the equipment items selected, auditors' audit tests were

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

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

designed to either “pass” or “fail” the accuracy of logistical system information. For a number of critical systems tested, it was agreed with the military leaders who used those systems that a system would “pass” only where all assets selected from the system were found. For other systems, which generally carry information on less critical assets, it was agreed that the system could still receive a passing grade with up to two errors identified.

Auditors tested recorded information for 11 categories of Navy military equipment. Fiscal year 1997 testing of critical Navy logistics systems showed that the Navy’s systems failed for 3 of 11 categories of military equipment tested. Specifically, auditors determined that the Navy’s systems relied on for visibility or accountability over active boats, service craft, and uninstalled engines failed because the data were either incomplete or included assets that no longer existed. For example, tests of these mission critical systems found 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 inactive, indicating their availability to meet rapid mobilization requirements.
- Of 105 uninstalled engines sampled, 10 valued at up to \$4 million could not be found.

Because of the severity of these problems, a working group was established in 1998 to begin addressing them. Navy officials indicated that not adhering to established policies and procedures—for example, those related to the disposal of assets—coupled with disincentives to accurately report asset activity, significantly contributed to these inaccuracies. Officials stated that steps have been taken, including training personnel in existing procedures, and that weapon systems activity is expected to be accurately reported in fiscal year 1999. However, because the problems had not been addressed at the time of their audit, Navy auditors did not repeat tests of national defense assets for fiscal year 1998.

For fiscal year 1997, the Air Force logistics systems tested, including those supporting aircraft, missiles, and uninstalled engines, passed auditors’ tests and auditors made recommendations to correct the minimal number of

inaccuracies found during the tests. However, as part of the fiscal year 1998 financial statement audit work, auditors were unable to verify the reported data on 8,387 uninstalled engines, with an estimated value in excess of \$8 billion. This occurred because the Comprehensive Engine Management System (CEMS), which is used to report data on these assets, could not separately identify additions and deletions of engines during the fiscal year—a basic control for ensuring accountability over assets.

Audit tests for fiscal year 1997, using the pass-fail approach previously discussed, found that the Army's property books maintained by the local units were generally accurate for major equipment items held by those units. However, 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 reported²¹ that CBS-X was inaccurate because it (1) does not effectively capture data on equipment transactions from all Army units, (2) reflects software errors, and (3) contains transaction posting errors. In addition, like the Air Force's CEMS, CBS-X does not provide accountability and control over Army assets by tracking additions and deletions to asset quantities on hand. Our January 1998 report included over 20 specific recommendations, with which the Army generally concurred, directed towards improving CBS-X accuracy.

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

Short-term Improvements Underway. The Army and Navy have established working groups to develop plans for addressing problems related to

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

national defense asset accountability. In addition, the Air Force has hired a contractor to assist in implementing accounting standards by developing definitions for differentiating national defense assets from general plant, property and equipment assets.

Reported Environmental/ Disposal Liability Significantly Understated

As we testified last year, DOD has not yet fully implemented the federal accounting standard²² that requires it to recognize and report liabilities associated with environmental cleanup and/or disposal of its assets. DOD reported \$34 billion in estimated liabilities in its fiscal year 1998 financial statements for environmental restoration of active and inactive bases, cleanup of formerly used sites, and cleanup and disposal of certain chemical weapons. However, it did not estimate environmental cleanup and disposal costs associated with military weapon systems (such as aircraft, missiles, ships, and submarines), and ammunition. Further, DOD reported only a small portion of the total cost, estimated to be over \$10 billion, for removing unexploded ordnance from its training ranges. As a result, DOD's undisclosed liability in this area is likely understated by tens of billions of dollars. This was a significant factor contributing to our conclusion that the government's environmental and disposal liabilities were understated in its financial statements.²³

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

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

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

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

Reported Liability for Post-Retirement Health Care Unsupported

Last year, we reported that DOD did not accumulate the data necessary to accurately estimate its military post-retirement health benefits liability, and this remained a problem for fiscal year 1998. Instead of the required cost data, DOD used budget obligations to calculate its \$223 billion estimated liability. However, budget obligations may not capture the full costs of treatment facilities or some personnel costs, such as pension benefits. In addition, the costs represented by budget obligations differed significantly from the costs in DOD's official medical cost accounting system, the Medical Expense and Performance Reporting System, and the two were not reconcilable. DOD needs reliable cost data to estimate its future retiree health care liability but, more importantly, to properly allocate its resources, decide whether to provide services internally or through an outside party, set third-party billing rates, and benchmark its health care delivery system with those of other providers.

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

Short-term Improvements Underway. DOD has made progress in addressing the issues noted in prior years and has additional improvements

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

Cost of DOD Operations Not Accurate

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

To effectively, efficiently, and economically manage DOD's programs, its managers need reliable cost information for (1) evaluating programs, such as, for example, measuring actual results of management's actions against expected savings or determining the effect of long-term liabilities created by current programs, (2) making economic choices, such as whether to outsource specific activities and how to improve efficiency through technology choices, (3) controlling costs for its weapon systems and business activities funded through working capital funds, and

(4) measuring performance. As we recently testified, the lack of reliable, cost-based information hampers DOD in each of these areas.²⁴ For example:

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

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

Reliability of Budget Data Impaired

For fiscal year 1998 reporting, federal accounting standards required agencies to prepare a new Statement of Budgetary Resources that would reconcile their reported net costs to budget information. As part of the DOD fiscal year 1998 financial statement audit, auditors found several areas in which the systems and controls over DOD's use of its budgetary resources were ineffective: (1) DOD does not know the true amount of funds that are available to obligate and spend in its appropriation accounts

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

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

because obligated balances are not always correct or supported, (2) reconciliations between DOD and Treasury records are not being adequately performed, (3) interagency transactions are not being identified and reconciled, and (4) certain disbursements are not being recorded promptly in DOD's accounting records. As a result, the Congress cannot be assured that DOD did not overexpend its budget authority for individual appropriation accounts or spend more for specific programs for which the Congress established spending limits. Conversely, these fund control weaknesses also result in the department's inability to properly identify and manage remaining budget authority, so that funds the Congress intended for specific DOD programs may be unused and eventually cancelled.

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

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

As of September 30, 1998, a comparison of DOD's and Treasury's records showed that the absolute value of unresolved differences amounted to \$9.6 billion, of which \$7.4 billion related to checks disbursed and the remainder to deposits, electronic funds transfers, and interagency transactions. These unresolved differences could significantly affect the

status of budget authority available to be obligated and expended. Differences between DOD and Treasury records can result from one or more of the following: (1) DOD delays in reporting transactions to Treasury, (2) Treasury delays in posting transactions to DOD accounts, and (3) errors or fraud.

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

DOD’s records also show that an estimated \$823 million held in suspense accounts at the end of fiscal year 1998 have not been properly reported to Treasury and are not reflected in the differences between Treasury and DOD records noted above. Until these transactions are posted to the proper appropriation account, the department will have little assurance that the collections and adjustments recorded in these accounts are authorized transactions and that its disbursements do not exceed appropriated amounts. Moreover, the reported \$823 million represents the offsetting (netting) of collections and adjustments against disbursements, thus understating the magnitude of the unreported amounts. For example, audit work for fiscal year 1997 found that, while the Navy had a net balance of \$464 million in suspense accounts recorded in its records for fiscal year 1997, the individual transactions, collections as well as disbursements, totaled about \$5.9 billion.

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

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

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

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

DOD reported problem disbursements at \$17.3 billion as of September 30, 1998. To the extent that these disbursements cannot be matched to existing recorded obligations, DOD would be required to

record a new obligation, which could create an Antideficiency Act²⁶ violation if the available unobligated balances in the department's applicable appropriation accounts were insufficient to cover the amount of the obligation.

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

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

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

DOD has a number of initiatives to address problem disbursements, including (1) implementation of a single cash accountability system that will be used to report disbursements to the U.S. Treasury and

²⁶The Antideficiency Act provides that an officer or employee of the United States government may not "make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund" or enter into a contract or other obligation for the payment of money "before an appropriation is made." (31 U.S.C. 1341 (a))

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

(2) prevalidation. The prevalidation initiative requires that obligations be matched to disbursements before the payment is made.

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

Extent of Improper Payments Not Fully Determinable

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

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

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

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

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

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

- An August 1998 Naval Audit Service report²⁹ identified \$6.2 million in duplicate and erroneous Navy vendor payments out of \$369.2 million tested. Naval Audit concluded that these improper payments were caused by a lack of written policies and procedures for certifying and processing vendor invoices, certifying officer errors, accounting technician data input errors, and payment by two different paying activities for the same goods and/or services.
- In September 1998, we reported³⁰ on internal control and systems weaknesses that contributed to two cases of Air Force vendor payment fraud—one resulting in the embezzlement of over \$500,000 and the other resulting in the embezzlement of \$435,000 and attempted theft of over \$500,000. We found that the lack of segregation of duties and other control weaknesses, such as weak controls over remittance addresses, created an environment where employees were given broad authority and the capability, without compensating controls, to perform functions that should have been performed by separate individuals under proper supervision. We also found that over 1,800 DFAS and Air Force employees had a level of access to the vendor payment system that allowed them to submit all the information necessary to create fraudulent and improper payments.

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

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

Health Care Fraud. In February 1999, the DOD IG reported³¹ that the Defense Criminal Investigative Service (DCIS) had about 500 open criminal investigations on health care fraud. DCIS efforts over the last 5 fiscal years have resulted in 343 convictions and \$1 billion in recoveries. Generally, the health care fraud cases investigated by DCIS cover defective and fraudulent claims—the same issues as Medicare fraud. Under DOD’s fee-for-services health care programs, most provider fraud was accomplished through ordering and billing for unnecessary care, laboratory tests, durable medical equipment, or x-rays. For example, a pharmaceutical company submitted greatly inflated insurance billings through the unbundling of clinical test profiles, fabricating test codes, and double billing for tests not performed. The company agreed to pay \$325 million to resolve issues of civil false claims to Medicare and military and other federal and state health care programs.

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

Critical Areas to Be Addressed to Meet Financial Reform Goals

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

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

However, an unqualified audit opinion, while certainly important, is not an end in itself. Efforts to obtain reliable year-end data that are not backed up by fundamental improvements in DOD's underlying financial management systems and operations to support ongoing program management and accountability, will not achieve the intended results of the Chief Financial Officers Act—fundamentally reforming financial operations to enable the production of reliable financial management information supporting day-to-day decision-making. In this context, it is essential that DOD also establish a well-trained cadre of financial management personnel, a short-term improvement action that will help address the financial management weaknesses previously identified as well as help ensure that the improvement actions cited are implemented as efficiently and effectively as possible. Longer term actions addressed in DOD's first Biennial Plan also will be essential for the department to prepare reliable financial statements as well as to make planned major financial management system improvements throughout DOD's large and complex organization.

Enhanced Training for Financial Management Personnel

One of the key issues facing DOD is the need to ensure that its financial management personnel have the knowledge and skills required to reliably carry out the basic transaction processing activities that were previously discussed throughout DOD's large and complex organization. Our work³² has shown that state governments and private sector organizations place a strong emphasis on training as a means of upgrading financial workforce knowledge of accounting and financial management requirements. In contrast, the results of a survey we conducted of key DOD financial managers showed that over half of those surveyed had received no financial- or accounting-related training during 1995 and 1996.³³

DOD leadership has acknowledged that it needs to improve the capabilities of its financial managers, and DFAS is developing a program intended to identify the kinds of skills and developmental activities needed to improve the competencies of its financial personnel. We have recommended that DOD modify its planned program to better ensure that financial management personnel throughout the department receive necessary

³²Financial Management: Profile of Financial Personnel in Large Private Sector Corporations and State Governments (GAO/AIMD-98-34, January 2, 1998).

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

training, including establishing minimum training requirements emphasizing technical accounting and related financial management courses. This recommended approach is similar in scope to the program recently put in place to improve the skills of the department's acquisition workforce.

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

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

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

We have analyzed DOD's first plan and, in January 1999, reported³⁴ the results of our analysis to the Senate and House Armed Services Committees. As we stated in our report, DOD's plan represents a great deal of effort and provides a first-ever vision of the department's future financial management environment. In developing this overall concept of its envisioned financial management environment, DOD has taken an important first step in improving its financial management operations. The department's plan also represents a significant landmark because it includes, for the first time, a discussion of the importance of the programmatic functions of personnel, acquisition, property management, and inventory management to the department's ability to support consistent, accurate information flows to all information users. In addition, DOD's plan includes an extensive array of initiatives intended to move the

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

department from its current state to its envisioned financial management environment.

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

- **A revised concept of operations.** A revised concept of operations needs to reflect, at a high level, the full range of the department's financial management operations, including (1) how it will support budget formulation and (2) how its financial management operations will effectively support not only financial reporting, but also asset accountability and control. In particular, including the role of department's Planning, Programming, and Budgeting System (PPBS) in its concept of operations will be essential to the development of a fully integrated financial management system. Such an integrated system will help ensure that budgets consider financial implications and that policy decisions are based on sound financial information.
- **Shared servicing and outsourcing strategies.** Many leading organizations have used shared servicing strategies built on a three-staged process focused on (1) consolidation, (2) standardization, and (3) reengineering financial operations to reduce the cost of, and improve control over, day-to-day accounting operations. With respect to outsourcing, our October 1997 report³⁵ on the results of our survey of selected private sector and nonfederal public organizations' use of outsourcing showed that the following factors were fundamental to achieving projected cost savings, process cycle time reductions, and other expected financial management improvements: (1) developing a structured approach for identifying functional areas to be considered for outsourcing, (2) identifying the criteria to be used in determining whether or not to outsource a specific function, and (3) establishing effective controls to oversee outsourcing vendors.
- **Clarification of Transition Plan.** The transition plan needs to clarify the role that the 200 planned improvement initiatives will play in bridging the gap between the current environment and the envisioned future

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

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- concept of operations and the steps the department will take to ensure that it will build reliability into the data provided by its feeder systems.
- Concepts of Clinger-Cohen. The plan should include the concepts established in the Clinger-Cohen Act (40 U.S.C. 1401) for effectively implementing the technology improvement initiatives contained in the plan, including establishing processes to help ensure that such initiatives are implemented at acceptable costs, within reasonable and expected time frames, and are contributing to tangible, observable improvements in mission performance.

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

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

The Secretary of Defense has expressed the department's commitment to financial management reform. He recently announced that he was expanding his Defense Reform Initiative to include financial management. Achieving effective reform will entail the involvement and dedication of top management. Working through the Defense Management Council or a similar structure of the department's high-ranking leadership, such as that

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

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 to governmentwide financial management reform, such as that provided by this hearing, will be critical to instilling expected accountability in DOD and other agencies across government.

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

Related GAO Products

Property, Plant and Equipment

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

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

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

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