THE DEPARTMENT OF DEFENSE: WHAT MUST BE DONE TO RESOLVE DOD'S LONGSTANDING FINANCIAL MANAGEMENT PROBLEMS?

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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THE DEPARTMENT OF DEFENSE: WHAT MUST BE DONE TO RESOLVE DOD'S LONGSTANDING FINANCIAL MANAGEMENT PROBLEMS?

TUESDAY, MAY 8, 2001

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Putnam and Schakowsky.

Staff present: J. Russell George, staff director and chief counsel; Dianne Guensberg, detailee; Bonnie Heald, director of communications; Earl Pierce, professional staff member; Grant Newman, assistant to the committee; Alex Hurowitz, intern; Mark Stephenson, minority professional staff member; and Jean Gosa, minority assistant clerk.

Mr. HORN. The hearing of the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations will come to order.

We are here today to continue our examination of how the executive branch departments and agencies of the Federal Government account for the billions of tax dollars they spend each year. The subcommittee began its examination of the government's fiscal year 2000 financial statements with the release of the General Accounting Office's audit report on March 30, 2001.

For the 5th consecutive year, the General Accounting Office was unable to render an opinion on the reliability of the Federal Government's financial statements. In addition, GAO auditors found significant material deficiencies that adversely affected both the financial statements and the management of government operations.

According to the GAO, the Federal Government did not maintain effective internal controls and its financial statements did not substantially comply with the Federal Financial Management Improvement Act of 1996, Public Law 104–208.

Encouragingly, an increasing number of agencies were able to produce clean, auditable financial statements and made marked improvements in their financial statements and processes. However, this progress was often achieved through difficult and costly efforts. Despite that progress, the failures of a few agencies continue to tarnish the overall record of the executive branch.

Most disheartening, however, is the abysmal lack of achievement by two significant government departments and one agency. For the 5th consecutive year, the Agency for Intergovernmental Development and two of the government's largest departments, the Department of Defense and the Department of Agriculture, still cannot adequately account for the billions of tax dollars they spend. All three, again, received the unacceptable grade of F in the subcommittee's report card on Federal financial management.

Today we focus on what actions must be taken to resolve these financial issues. In this hearing, we will focus on the Department of Defense. The Department of Defense is cited as one of the primary reasons the Federal Government is unable to prepare auditable financial statements.

Specifically, the General Accounting Office, headed by the Comptroller General, found the Department of Defense cannot properly account for its assets; in particular, its property, plant and equipment, and inventories.

In addition, the Department cannot estimate the cost of cleaning-up and disposing of extensive environmental contaminants, including unexploded ordnance and residual contaminants from training ranges.

Finally, it cannot accurately document the net cost of its operations.

In fiscal year 2000, the Department of Defense spent $397 billion, 16 percent of the Federal Government's total spending of $2 trillion. Government spending on national defense is second only to that spent on human resource costs, such as Social Security, Medicaid, and Medicare.

Further, the Department of Defense controls an estimated $1 trillion in weapons systems and inventories. In fiscal year 2000, the Department's inventory, evaluated at an estimated $139 billion, accounted for 75 percent of the Federal Government's total inventories of $185 billion.

Despite the Department's enormous budget and inventory, its Inspector General has been unable to render an opinion on the reliability of the Department's financial statements. Similar to findings by the General Accounting Office, the Inspector General reported that significant material deficiencies adversely affected both the Department's financial statements and its ability to manage its day-to-day operations.

Further, the Inspector General found that the Department did not maintain effective internal controls and that its financial systems and management systems did not substantially comply with the Federal Financial Management Improvement Act of 1996.

Now we have a new administration which we hope will focus close attention on the Department of Defense's continuing failure to address its longstanding financial management problems.

We welcome our witnesses today: Gregory D. Kutz, Director of Defense, State and National Aeronautics and Space Administration Financial Management Issues, Financial Management and Assurance, U.S. General Accounting Office; Robert Lieberman, Deputy Inspector General, Department of Defense; and Lawrence J. Lanzillotta, Principal Deputy and Deputy Under Secretary for Management Reform.

Gentlemen, we look forward to your testimony, your insight, and your recommendations to end this intolerable financial situation at the Department of Defense.

[The prepared statement of Hon. Stephen Horn follows:]

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Opening Statement
Financial Management at the Department of Defense
Chairman Steve Horn
Subcommittee on Government Efficiency,
Financial Management and Intergovernmental Relations
May 8, 2001

A quorum being present, this hearing of the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations will come to order.

We are here today to continue our examination of how the executive branch departments and agencies in the federal government account for the billions of tax dollars they spend each year. The subcommittee began its examination of the government's fiscal year 2000 financial statements with the release of the General Accounting Office's audit report on March 30, 2001.

For the fifth consecutive year, the General Accounting Office was unable to render an opinion on reliability of the federal government's financial statements. In addition, GAO auditors found significant material deficiencies that adversely affected both the financial statements and the management of government operations.

According to the GAO, the federal government did not maintain effective internal controls and its financial management systems did not substantially comply with the Federal Financial Management Improvement Act of 1996 (FFMIA) (Public Law 104-208, Title VIII).

Encouragingly, an increasing number of agencies were able to produce clean, auditable financial statements and made marked improvements in their financial management systems and processes. However, this progress was often achieved through difficult and costly efforts. Despite that progress, the failures of a few agencies continue to tarnish the overall record of the executive branch.

Most disheartening, however, is the abysmal lack of achievement by two significant government departments and one agency. For the fifth consecutive year, the Agency for International Development, and two of the government's largest departments -- the Department of Defense and the Department of Agriculture -- still cannot adequately account for the billions of tax dollars they spend. All three, again, received the unacceptable grade of "F" in the subcommittee's report card on federal financial management.

In today's hearings, we will focus on what actions must be taken to resolve these financial issues. In this hearing, we will focus on the Department of Defense. The Department of Defense is cited as one of the primary reasons the federal government is unable to prepare auditable financial statements. Specifically, the GAO found:

- The Defense Department cannot properly account for its assets -- in particular its property, plant and equipment, and inventories.
- In addition, the department cannot estimate the cost of cleaning up and disposing of extensive environmental contaminants, including unexploded ordnance and residual contaminants from training ranges.
- Finally, it cannot accurately document the net cost of its operations.

In fiscal year 2000, the Department of Defense spent $397 billion -- 16 percent of the federal government's total spending of $2 trillion. Government spending on national defense is second only to that spent on human resource costs, such as Social Security, Medicaid and Medicare. Further, the Department of Defense controls an estimated $1 trillion in weapons systems and inventories. In fiscal year 2000, the department's inventory, valued at an estimated $139 billion, accounted for 75 percent of the federal government's total inventories of $185 billion.

Despite the department's enormous budget and inventory, its Inspector General has been unable to render an opinion on the reliability of the department's financial statements. Similar to findings by the GAO, the Inspector General reported that significant material deficiencies adversely affected both the department's financial statements and its ability to manage its day-to-day operations. Further, the Inspector General found that the department did not maintain effective internal controls and that its financial management systems did not substantially comply with the Federal Financial Management Improvement Act of 1996.

Now, we have a new Administration, which we hope will focus close attention on the Department of Defense's continuing failure to address its longstanding financial management problems.

We welcome our witnesses today: **Gregory D. Kutz,** Director of Defense, State and NASA Financial Management Issues, Financial Management and Assurance, U.S. General Accounting Office; **Robert Lieberman**, Deputy Inspector General, Department of Defense, and **Lawrence J. Lanzillotta,** Principal Deputy and Deputy Under Secretary for Management Reform.

Gentlemen, we look forward to your testimony, your insight, and your recommendations to end this intolerable financial situation at the Department of Defense.

Mr. HORN. I now yield for an opening statement to the ranking member, the gentlewoman from Illinois, Ms. Schakowsky.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman. Welcome to our witnesses.

The subcommittee recently held a hearing on the consolidated financial management for the U.S. Government. It was clear from that hearing that while there has been some improvement in financial management at many Federal agencies, at others serious problems remain.

The Department of Defense is perhaps the worst such problem agency, both because of the sheer magnitude of the amount of money involved and because of the seeming intractability of some of these financial management problems.

The Department of Defense receives approximately one-half of the discretionary budget of the United States each year. Its annual budget is about $310 billion. It owns assets valued at over $1 trillion. It has about 3 million military and civilian employees.

Despite, and maybe in part because of, the huge sums of money flowing through the Department, its financial management systems, practices, and procedures are hampered by critical weaknesses.

Since 1995, the GAO has designated the financial management systems at DOD as "high-risk" because they are vulnerable to waste, fraud and abuse. Again this year, as has been the case for at least the last 5, the Defense Inspector General could not provide an opinion on the agency's financial statements.

No major part of the Department has been able to pass the test of an independent audit. Of about $7 trillion—that is trillion with a T—in accounting entries at Defense, at least $1.2 trillion were not supported by sufficient evidence to determine their validity.

DOD could not properly account for hundreds of billions of dollars of its asset holdings, including weapons systems and support equipments. It lacks a complete and reliable inventory of its environmental liabilities, potentially understating by tens of billions the reported $63 billion liability. Its inventory exceeds its needs by nearly $30 billion.

DOD cannot reconcile payments to its contractors reliably. Between 1994 and 1999, defense contractors returned nearly $5.3 billion in overpayment.

These are not isolated incidents. Far from it. We have had literally decades of reports from GAO and from the Inspector General at Defense on the history of financial management problems at the Department.

Six years ago, in 1995, the DOD Inspector General testified before Congress that a turn-around in the Pentagon's financial management practices might be expected by the year 2000. Well, it is now 2001, and the IG is saying that the Department might have financial statements which can be audited by the middle of the decade.

This is not progress. I, for one, would support reducing the Pentagon's appropriations until these fundamental issues are addressed.

Thank you, Mr. Chairman.

Mr. HORN. Thank you.

[The prepared statement of Hon. Janice D. Schakowsky follows:]

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Opening Statement -- Rep. Janice D. Schakowsky
Hearings on Financial Management at the Department of Defense

May 8, 2001 - 10:00 A.M.

Thank you Mr. Chairman, and welcome to our witnesses.

The Subcommittee recently held a hearing on the consolidated financial statement for the United States Government. It was clear from that hearing that while there has been some improvement in financial management at many federal agencies, at others serious problems remain. The Department of Defense is perhaps the worst such problem agency, both because of the sheer magnitude of the amount of money involved, and because of the seeming intractability of some of these financial management problems.

The Defense Department receives approximately one-half of the discretionary budget of the United States each year. It's annual budget is about $310 billion, it owns assets valued at over $1 trillion, and has about 3 million military and civilian employees. Despite, and maybe in part because of, the huge sums of money flowing through the department, its financial management systems, practices, and procedures are hampered by critical weaknesses. Since 1995, GAO has designated the financial management systems at DoD as "high risk," because they are vulnerable to waste, fraud, and abuse. And again this year, as has been the case for at least the last five, the Defense Inspector General could not provide an opinion on the agencies financial statements. And no major part of the Department has been able to pass the test of an independent audit

Of about $7 trillion – that's trillion with a "T" – in accounting entries at Defense, at least $1.2 trillion were not supported by sufficient evidence to determine their validity. DOD can not properly account for hundreds of billions of dollars of its asset holdings, including weapon systems and support equipment. It lacks a complete and reliable inventory of it environmental liabilities, potentially understating by 10's of billions the reported $63 billion liability. It's inventory exceeds its needs by nearly $30 billion. DoD can't reconcile payments to its

contractors reliably – between 1994 and 1999, defense contractors returned nearly $5.3 billion in overpayment

These are not isolated incidents, far from it. We have had literally decades of reports from GAO and from the Inspector General at Defense on the history of financial management problems at the Department. Six years ago, in 1995, the DoD Inspector General testified before Congress that a turnaround in the Pentagon's financial management practices might be expected by the year 2000. Well it now 2001, and the IG is saying the Department might have financial statements which can be audited by the middle of the decade. This is not progress. And I for one, would support reducing the Pentagon's appropriation until these fundamental issues are addressed.

Thank you Mr. Chairman.

Mr. HORN. I think most of you are regulars, so you know our little routine here. I will be swearing you in, and then the agenda is the one we see in front of you, and we will just go down the line.

We would like it very much if you could summarize in 5 or, at the most, 10 minutes. We have essentially an hour and a half, and we would like to have a chance for questions on this. So once I call on your name, your full statement is automatically in the record all the rest of the day. We are going to be here until about 2:30—not with all of you, hopefully.

If you will stand and raise your right hands, please. Any who are backing you up, please have them stand, too.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all of you nodded your head or affirmed to the oath.

We will start with Mr. Kutz, Gregory D. Kutz, Director for Defense, State, and National Aeronautics and Space Administration Financial Management and Assurance of the U.S. General Accounting Office.

Mr. Kutz.

STATEMENTS OF GREGORY D. KUTZ, DIRECTOR FOR DEFENSE, STATE AND NASA FINANCIAL MANAGEMENT, FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY DAVID R. WARREN, DIRECTOR FOR LOGISTICS, DEFENSE CAPABILITIES AND MANAGEMENT; ROBERT J. LIEBERMAN, DEPUTY INSPECTOR GENERAL, U.S. DEPARTMENT OF DEFENSE; AND LAWRENCE J. LANZILLOTTA, PRINCIPAL DEPUTY AND DEPUTY UNDER SECRETARY FOR MANAGEMENT REFORM, U.S. DEPARTMENT OF DEFENSE

Mr. KUTZ. Mr. Chairman and Representative Schakowsky, good morning. It is a pleasure to be here to testify on the need for financial management reform at the Department of Defense.

With me is Dave Warren, a Director on our Logistics, Defense Capabilities, and Management team.

The financial activity of DOD is enormous when compared to other entities, with a reported $1 trillion in both assets and liabilities, nearly $350 billion in net program costs, and a workforce of about 3 million.

To provide some perspective on the size of DOD, consider that it had 30 times more employees, at least 4 times more in assets, and spent $140 billion more than ExxonMobil in fiscal year 2000.

Currently, the United States is the world's sole superpower, with military forces that are second to none. However, the same level of excellence is not evident in many of DOD's business processes, including financial management.

The bottom line of my testimony this morning is that, although incremental progress has been made in recent years, DOD financial management reform has largely failed. As a result, substantial waste and inefficiency exists and, in some cases, mission performance is placed at risk.

My testimony this morning has three parts: first, a brief discussion of DOD's financial management weaknesses; second, the un-

derlying or root causes of those weaknesses; and, third, the key elements necessary for successful reform.

First, some of DOD's more significant financial management weaknesses include asset accountability, budget execution accounting, environmental liability reporting, cost accounting, and financial management systems.

I would like to highlight several examples of the operational impact of some of these weaknesses. Clearly, asset accountability problems—not knowing what you have or where it is located—can impact mission performance. For example, during fiscal year 2000, we found that Army managers lost accountability for and visibility of about 62,000 missiles, rockets, and other ammunition that were stored at four test facilities.

This inventory was reported in test facility records. However, the items were excluded from the Army's central visibility records for nearly 2 years. These visibility records are used to manage inventory for readiness and procurement decisions, along with financial reporting. These visibility items at the test facilities include handheld, ready-to-fire Stinger and Javelin missiles.

Loss of accountability has resulted in DOD purchasing items that it already has. Also, shortages of spare parts—the direct result of poor inventory controls—have resulted in aircraft being grounded and the need to cannibalize good parts from aircraft in order to complete repairs.

In the area of budget execution accounting, for years we have reported that DOD has overpaid contractors because of duplicate payments or otherwise erroneous. Private sector companies devote resources to collecting amounts due from customers for goods and services provided. In contrast, DOD devotes resources to collecting its own overpayments to contractors.

Mr. Chairman, given your interest in debt collection, you will find the next example a telling one. From DOD's Debt Collection Office at the DFAS Columbus Center, we recently chose 10 cases of amounts from contractors for overpayments. For these cases, we attempted to collect the amounts due using DFAS' own policies and procedures.

Using only basic debt collection practices, we were successful in facilitating full collection of five cases, including interest and penalties, for about $103,000. As this example demonstrates, many of DOD's financial management weaknesses could be solved if people simply followed existing policies and procedures.

Going on to my second point, which relates to the underlying causes of DOD's financial and other management problems, we believe the underlying reasons for failed reform include a lack of top-level leadership and accountability; cultural resistance to change, including service parochialism; lack of results-oriented goals and performance measures; and inadequate incentives for seeking change.

In our executive guide on world-class financial management, the leading organizations we studied, including General Electric, Boeing, and Pfizer, identified leadership as the most important factor in making cultural changes and establishing effective financial management.

DOD has not traditionally established accountability for performance to specific individuals or organizations with the authority to implement change. For example, the DOD Comptroller, also the Chief Financial Officer, has direct responsibility for only an estimated 20 percent of the data relied on for financial management operations.

DOD learned from the year 2000 computing crisis that active leadership from the Deputy Secretary is the key to success. Such top-level leadership will be necessary to transform the DOD culture and reform financial management.

One of the goals of financial reform is for agencies to develop timely, reliable financial information for decisionmaking purposes. For financial management, the primary goal at DOD has been to get an unqualified or clean audit opinion. This approach has resulted in millions of dollars being spent on contractors to perform ad hoc work-around procedures designed to develop one-time numbers for annual financial reporting.

Although many agencies, including IRS, have successfully done these work-arounds to get clean opinions, these costly procedures do not result in lasting or meaningful change. In fact, what they do is create the need to replicate the process annually in order to maintain the clean opinion.

In the case of DOD, the financial management problems are so severe that it may not be possible to get a clean opinion using these work-arounds. The new DOD team will need to carefully balance the resources expended on short-term efforts to achieve a clean opinion with the long-term efforts needed to truly reform Defense financial management.

My third part relates to the key elements necessary for reform. Going forward, various approaches could be used to address the underlying causes of financial management weaknesses. Our written statement discusses what we believe are seven key elements to successful reform. I will now discuss two of those seven.

First, financial management challenges must be addressed in a comprehensive, integrated, DOD-wide business process reform. An improvement strategy cannot be developed in a vacuum. Financial management is a cross-cutting issue that affects all of an organization's business processes.

Currently, DOD has 6 of the 21 agency-specific high-risk areas in the Federal Government, including information technology and logistics. In addition, our two governmentwide high-risk areas—human capital strategy and computer security—are also relevant to DOD. These interrelated management challenges must be addressed using an integrated, enterprise-wide approach.

Second, we believe effective oversight and monitoring of DOD's strategy and progress is critical. I commend the subcommittee for holding a series of DOD financial management hearings over the last several years. Oversight hearings like the one today shine light on this serious matter and provide a constructive dialog for discussing progress made and actions needed.

The Defense Inspector General and GAO can contribute by providing our professional, objective, and constructive assistance in reforming financial management.

In summary, reforming DOD financial management is a monumental challenge. Reform will require sustained, top-level leadership and a cultural transformation.

Without addressing the underlying causes of the current situation, DOD will continue to make incremental change but will not achieve the dramatic improvements needed for effective financial management. With hundreds of billions of dollars in annual DOD spending, true financial management reform is needed to restore public confidence that these taxpayer dollars are well spent in meeting the Nation's Defense objectives.

Mr. Chairman, this concludes my statement. Mr. Warren and I would be happy to answer questions after the other witnesses have given their testimony.

Mr. HORN. Thank you very much for that very helpful overview. We will get back to that in the questions.

[The prepared statement of Mr. Kutz follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected
at 10 a.m. Tuesday,
May 8, 2001

DOD FINANCIAL MANAGEMENT

Integrated Approach, Accountability, and Incentives Are Keys to Effective Reform

Statement of Gregory D. Kutz, Director, Financial Management and Assurance

GAO-01-681T

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss the status of financial management at the Department of Defense (DOD). Mr. Chairman, I want to commend you for holding this hearing today. As our nation moves into the 21st century, the 107th Congress and the new administration face an array of challenges and opportunities to enhance the performance and assure the accountability of the federal government for the benefit of all Americans. For DOD, changing security threats, increased globalization, and rapid technological advances are prompting fundamental changes in the environment in which it operates. These trends are placing a premium on increasing strategic planning, using integrated approaches, enhancing results-orientation, and ensuring accountability.

With DOD spending currently representing about 16 percent of the federal budget–down from 50 percent in 1962, it is increasingly important that it get the most from every Defense dollar spent. Each Defense dollar that is spent inefficiently is a dollar that is unavailable to meet other departmental priorities, such as weapon system modernization and readiness, or to meet other governmentwide needs. Over the past few years, DOD has made incremental improvements in financial management. However, the results of the department's fiscal year 2000 financial audit are one indicator of the continuing serious and pervasive weaknesses in its financial management systems, operations, and internal controls that have impeded the development of useful, reliable, and timely financial information for day-to-day management and decision-making.

The department's financial management problems are closely tied to its other seven major management challenges—strategic planning, human capital, information technology, acquisition, contract management, support infrastructure, and logistics. An estimated 80 percent of the data needed for sound financial management comes from the department's other business operations, such as acquisitions and logistics. As discussed in our January 2001 reports[1] addressing the major performance and accountability challenges and high-risk areas facing DOD, while our military forces are second to none, this same level of excellence is not evident in many of the business processes that are critical to achieving the department's mission in a reasonably economical, efficient, and effective manner. These eight key interrelated areas represent the department's greatest challenge to developing world-class operations to support its forces.

Today, I will focus on (1) an overview of the long-standing financial management challenges facing DOD—as highlighted by the recent results of the fiscal year 2000 financial audit, (2) the underlying causes of DOD's inancial management weaknesses, and (3) key actions necessary to correct DOD's financial management problems as part of a fundamental business process reform.

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[1] *Major Management Challenges and Program Risks: Department of Defense* (GAO-01-244, January 2001) and *High-Risk Series* (GAO-01-263, January 2001).

Long-standing Financial Management Weaknesses Continue

We have been reporting on the department's financial management as an area of high risk since 1995.[2] As discussed in our recent report on the results of our review of the fiscal year *2000 Financial Report of the U.S. Government,*[3] DOD's financial management deficiencies, taken together, continue to represent the single largest obstacle to achieving an unqualified opinion on the U.S. government's consolidated financial statements. To date, none of the military services or major DOD components have passed the test of an independent financial audit because of pervasive weaknesses in financial management systems, operations, and controls.

These weaknesses not only hamper the department's ability to produce timely and accurate financial management information, but also make the cost of carrying out missions unnecessarily high. Ineffective asset accountability and the lack of effective internal controls continue to adversely affect visibility over its estimated $1 trillion investment in weapon systems and inventories. Such information is key to meeting military objectives and readiness goals. Further, unreliable cost and budget information related to nearly a reported $1 trillion of liabilities and about $347 billion of net costs negatively affects DOD's ability to effectively measure performance, reduce costs, and maintain adequate funds control. As the results of the department's fiscal year 2000 financial audit and other recent auditors' reports demonstrate, DOD continues to confront serious weaknesses in the following areas.

Budget execution accounting. The department was unable to reconcile an estimated $3.5 billion difference between its available fund balances according to its records and Treasury's at the end of fiscal year 2000—similar in concept to individuals reconciling their checkbooks with their bank statements. In addition, the department made frequent adjustments of recorded payments between appropriation accounts, including adjustments to cancelled appropriation accounts[4] of at least $2.7 billion during fiscal year 2000. In addition, a number of obligations were incorrect or unsupported. For example, auditors found that $517 million of the $891 million in recorded Air Force fiscal year 2000 obligations tested were not supported. Further, the department could not fully and accurately account for an estimated $1.8 billion of transactions that were held in suspense accounts[5] at the end of fiscal year 2000.

The net effect of DOD's problems in this area is that it does not know with certainty the amount of funding it has available. Until the department can effectively reconcile its

[2]GAO has designated government operations and programs as "high risk" because of either their greater vulnerabilities to waste, abuse, and mismanagement or major challenges associated with their economy, efficiency, or effectiveness.

[3]*U.S. Government Financial Statements: FY 2000 Reporting Underscores the Need to Accelerate Federal Financial Management Reform* (GAO-01-570T, March 30, 2001).

[4]Agencies are required to account for obligated and unobligated balances of their appropriations for 5 years after the expiration of their period of availability. At the end of 5 years, appropriation balances, both obligated and unobligated, are cancelled.

[5]A suspense account is a temporary holding account for problem transactions—for example, those rejected because of system edit controls.

available fund balances and Treasury's, ensure that payments are posted to the correct appropriation accounts, and post amounts held in suspense accounts to the proper appropriation accounts, the department will have little assurance that reported appropriation balances are correct. Such information is essential for DOD and the Congress to determine if funds are available that could be used to reduce current funding requirements or that could be reprogrammed or transferred to meet other critical program needs.

Environmental and disposal liabilities. The amounts of environmental and disposal liabilities the department has reported over the last few years has varied by tens of billions of dollars—from $34 billion in fiscal year 1998, up to $80 billion in fiscal year 1999, and down to $63 billion in fiscal year 2000. However, these reported amounts potentially excluded billions of dollars of future liabilities associated with DOD's non-nuclear weapons; conventional munitions; training ranges; and other property, plant and equipment—such as landfills. For example, we recently reported[6] that while DOD reported a fiscal year 2000 liability of $14 billion associated with its environmental cleanup of training ranges, other DOD estimates show that this liability could exceed $100 billion. Obtaining reliable estimates of the department's environmental liability is an important factor for DOD managers and oversight officials to consider with respect to the likely timing of related funding requests and DOD's ability to carry out its environmental cleanup and disposal responsibilities.

Asset accountability. DOD has continued to experience problems in properly accounting for and reporting on its weapon systems and support equipment. Material weaknesses continue in the central systems DOD relies on to maintain visibility over assets critical to meeting military objectives and readiness goals. For example, in fiscal year 1999, auditors found that Army's central visibility system excluded information on 56 airplanes, 32 tanks, and 36 Javelin command-launch units. Auditors' fiscal year 2000 financial audit testing showed that previously identified problems in the systems and processes that DOD relied on to account for and control its large investment in weapon systems had not yet been corrected.

In addition, DOD's inability to account for and control its huge investment in inventories has been an area of major concern for many years.[7] For example, auditors' fiscal year 2000 reviews revealed that (1) Army did not perform required physical counts for wholesale munitions with an estimated value of $14 billion and (2) central accountability and visibility records at four Army test facilities excluded data on about 62,000 missiles, rockets, and other ammunition items that were on hand. In addition, physical counts at the Defense Logistics Agency's 20 distribution depots showed that none of the depots achieved the department's goal of 95 percent inventory record accuracy--with error rates ranging from 6 to 26 percent.

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[6] *Environmental Liabilities: DOD Training Range Cleanup Cost Estimates Are Likely Understated* (GAO-01-479, April 11, 2001).
[7] GAO-01-263.

As a result of continuing problems in this area, the department continues to spend more than necessary to procure inventory and at the same time, experience equipment readiness problems because of the lack of key spare parts. For example, we reported that because of long-standing weaknesses in controls over shipments, the department's inventories are at high risk for undetected loss and theft. At the same time, and for a number of years, insufficient spare parts have been recognized as a major contributor to aircraft performing at lower mission capable rates than expected. Our recent reporting[8] disclosed that inaccurate, inconsistent, and missing pricing data for weapon system spare parts undermined military units' ability to buy needed spare parts.

Net Cost Information Unreliable. A continuing inability to capture and report the full cost of its programs represents one of the most significant impediments facing the department. DOD does not yet have the systems and processes in place to capture the required cost information from the hundreds of millions of transactions it processes each year. Consequently, while DOD reported $347 billion in total net costs for its fiscal year 2000 operations, it was unable to support this amount.

The lack of reliable, cost-based information hampers DOD across nearly all its programs and operations. For example, recent reporting highlights the adverse impact the lack of such information has had on the department's studies conducted under Office of Management and Budget (OMB) Circular A-76 and its performance measurement and cost reduction efforts. For example, in December 2000, we reported[9] that our review of DOD functions that were studied over the past 5 years for potential outsourcing under OMB Circular A-76 showed that while DOD reported that savings had occurred as a result of these studies, we could not determine the precise amounts of any such savings because the department lacks actual cost data.

Lacking complete and accurate overall life-cycle cost information for weapon systems impairs DOD and congressional decisionmakers' ability to make fully informed judgments on funding comparable weapon systems. DOD has acknowledged that the lack of a cost accounting system is the single largest impediment to controlling and managing weapon system costs, including the cost of acquiring, managing, and disposing of weapon systems.

In addition, the measures used in the department's reporting under the Government Performance and Results Act (GPRA) often did not address the cost-based efficiency aspect of performance, making it difficult for DOD to fully assess the efficiency of its performance. For example, we reported[10] that while DOD's performance plan for 2001

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[8] *Defense Acquisitions: Prices of Marine Corps Spare Parts Have Increased* (NSIAD-00-123, July 31, 2000), *Defense Acquisitions: Price Trends for Defense Logistics Agency's Weapon System Parts* (GAO-01-22, November 3, 2000), and *Navy Aviation Spare Parts Billing Transaction Issues* (GAO-01-178R, January 11, 2001).

[9] *DOD Competitive Sourcing: Results of A-76 Studies Over the Past 5 Years* (GAO-01-20, December 7, 2000).

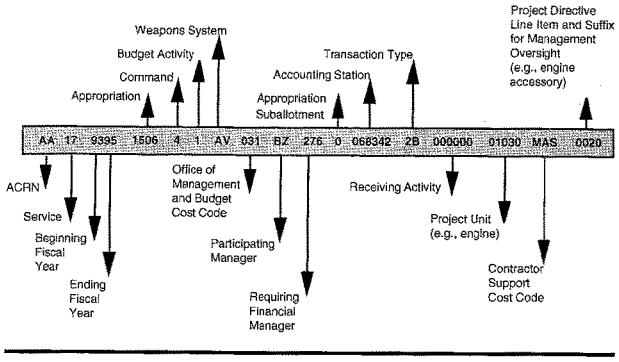
[10] *Observations on the Department of Defense's Fiscal Year 1999 Performance Report and Fiscal Year 2001 Performance Plan* (GAO/NSIAD-00-188R, June 30, 2000).

included 45 unclassified metrics, few metrics contained efficiency measures based on costs.

Financial management systems. DOD lacks integrated, transaction-driven, double entry accounting systems that are necessary to properly control assets and control costs. DOD has acknowledged that, overall, its reported network of 167 critical financial management systems does not comply with the Federal Financial Management Improvement Act's federal financial management systems requirements.

DOD's transaction processing, using a large network of systems relied on to carry out its financial management operations, is overly complex and error-prone. Each of the military services continue to operate many stand-alone, nonstandard financial processes and systems. As a result, millions of transactions must be manually keyed and rekeyed into the vast number of systems involved in any given DOD business process. To further complicate processing, transactions must be recorded using a coding structure that, as illustrated in the following figure, can exceed 50 digits.

Figure 1: Example of DOD's Accounting Coding



Source: DOD

DOD uses such coding—which according to DOD can exceed 75 digits–to accumulate appropriation, budget, and management information for contract payments. In addition, such accounting coding often differs—in terms of type, quantity, and format of data required–by military service and fund type.

As a result, financial accountability is lacking and financial management information available for day-to-day decision-making is poor. Weak systems and controls leave the department vulnerable to fraud and improper payments. For example, DOD continues to overpay contractors. Although the full extent of overpayments is not known, the department has an annual budget for purchases involving contractors of over $130 billion. In October 2000, we reported[11] that of the $3.6 billion DOD reported in its fiscal year 1999 financial statements as uncollected debt related to a variety of contract payment problems, at least $225 million represented improper payments, including duplicate payments, overpayments, and payments for goods not received. Without effective controls over this important area, DOD will continue to risk erroneously paying contractors millions of dollars and incur additional, unnecessary costs to collect amounts owed from contractors.

Underlying Causes of Financial and Related Business Process Reform Challenges

DOD has initiated a number of departmentwide reform initiatives to improve its financial operations as well as other key business support processes. These initiatives have produced some incremental improvements, but have not resulted in the fundamental reform necessary to resolve these long-standing management challenges.

The underlying causes for the department's inability to resolve its long-standing financial management problems, as well as the other areas of its operations most vulnerable to waste, fraud, abuse, and mismanagement were first identified in our May 1997 testimony.[12] These conditions remain largely unchanged today. Specifically, we believe the underlying reasons for the department's inability to put fundamental reforms of its business operations in place are

- a lack of top-level leadership and management accountability for correcting problems;
- cultural resistance to change, including service parochialism and stovepiped operations;
- a lack of results-oriented goals and performance measures and monitoring; and
- inadequate incentives for seeking change.

Lack of leadership and accountability. DOD has not routinely established accountability for performance to specific organizations or individuals that have sufficient authority to accomplish desired goals. For example, under the CFO Act, it is the responsibility of

[11] *Financial Management: Billions in Improper Payments Continue to Require Attention* (GAO-01-44, October 27, 2000).
[12] *DOD High-Risk Areas: Eliminating Underlying Causes Will Avoid Billions of Dollars in Waste* (GAO/T-NSIAD/AIMD-97-143, May 1, 1997).

agency CFOs to establish the mission and vision for the agency's future financial management. However, at DOD, the Comptroller—who is by statute the department's CFO--has direct responsibility for only an estimated 20 percent of the systems relied on to carry out the department's financial management operations. The department has learned through its efforts to meet the Year 2000 computing challenge that to be successful, major improvement initiatives must have the direct, active support and involvement of the Secretary and Deputy Secretary of Defense. Such top-level support helps guarantee that daily activities throughout the department remain focused on achieving shared, agency-wide outcomes.

DOD experience has suggested that top management has not had a proactive, consistent, and continuing role in building capacity, integrating daily operations for achieving performance goals, and in creating incentives. Sustaining top management commitment to performance goals is a particular challenge for DOD. In the past, a turnover rate among the department's top political appointees of 1.7 years hindered long-term planning and follow-through.

Cultural Resistance and Parochialism. Cultural resistance to change and service parochialism have also played a significant role in impeding DOD management reforms. DOD has acknowledged that it confronts decades-old problems deeply grounded in the bureaucratic history and operating practices of a complex, multifaceted organization, and that many of these practices were developed piecemeal and evolved to accommodate different organizations, each with its own policies and procedures.

For example, as discussed in our July 2000 report,[13] the department has encountered resistance to developing departmentwide solutions under the Secretary's broad-based Defense Reform Initiative (DRI).[14] The department established a Defense Management Council—including high-level representatives from each of the military services—which was intended to serve as the "board of directors" to help break down organizational stovepipes and overcome cultural resistance to changes called for under DRI. However, we found that the council's effectiveness was impaired because members were not able to put their individual military services' or DOD agencies' interests aside to focus on departmentwide approaches to long-standing problems.

We have also seen an inability to put aside parochial views and cultural resistance to change impeding reforms in the department's weapon system acquisition and inventory management areas. For example, as we recently reported,[15] while the individual military services conduct considerable analyses justifying major acquisitions, these analyses can be narrowly focused and do not consider joint acquisitions with the other services. In the inventory management area, DOD's culture has supported buying and storing multiple layers of inventory rather than managing with just the amount of stock needed.

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[13] *Defense Management: Actions Needed to Sustain Reform Initiatives and Achieve Greater Results* (GAO/NSIAD-00-72, July 25, 2000).

[14] Announced by the Secretary of Defense in 1997, DRI represents a set of actions aimed at reforming the department's major business processes and support operations.

[15] *Major Management Challenges and Program Risks: Department of Defense* (GAO-01-244, January 2001).

Unclear Goals and Performance Measures. Further, DOD's reform efforts have been handicapped by the lack of clear, hierarchically linked goals and performance measures. As a result, DOD managers lack straightforward road maps showing how their work contributes to attaining DOD's strategic goals, and they risk operating autonomously rather than collectively. In some cases, DOD had not yet developed appropriate strategic goals, and in other cases, its strategic goals and objectives were not linked to those of the military services and defense agencies.

As part of our assessment of *DOD's Fiscal Year 1999 Performance Report*, we reported[16] that it did not include goals or measures for addressing its contracting challenge, and it was not clear whether the department had achieved identified key program outcomes. The department's 1999 performance report did not provide any information on whether DOD is achieving any reduction in the important area of erroneous payments to contractors nor did it provide any cost-based measures for whether the department had achieved its desired outcome of putting in place a more efficient and cost-effective infrastructure and associated operating procedures.

Many of the department's business processes in operation today are mired in old, inefficient processes and systems, many of which are based on 1950s and 1960s technology. The department faces a formidable challenge in responding to technological advances that are changing traditional approaches to business management as it moves to modernize its systems. For fiscal year 2000, DOD reported total information technology investments of over $21 billion supporting a wide range of military operations as well as its business functions, including an estimated $7.6 billion in major information system projects. While DOD plans to invest billions of dollars in modernizing its financial management and other business support systems, it does not yet have an overall blueprint—or enterprise architecture—in place to guide and direct these investments.

Lack of Incentives for Change. The final underlying cause of the department's inability to carry out needed fundamental reform is the lack of incentives for making more than incremental change to existing "business as usual" processes, systems, and structures. Traditionally, DOD has focused on justifying its need for more funding rather than on the outcomes its programs produced. DOD generally measures its performance by the amount of money spent, people employed, or number of tasks completed. Incentives for DOD decisionmakers to implement changed behavior have been minimal or nonexistent.

This underlying problem has perhaps been most evident in the department's acquisition area. In DOD's culture, the success of a manager's career has depended more on moving programs and operations through the DOD process rather than on achieving better program outcomes. The fact that a given program may have cost more than estimated, took longer to complete, and did not generate results or perform as promised is secondary to fielding a new program. To effect real change, actions are needed to (1) break down parochialism and reward behaviors that meet DOD-wide and congressional

[16]GAO/NSIAD-00-188R, June 30, 2000.

goals, (2) develop incentives that motivate decisionmakers to initiate and implement efforts that are consistent with better program outcomes, and (3) facilitate a congressional focus on results-oriented management, particularly with respect to resource allocation decisions.

Keys to Fundamental DOD Business Process Reform

The new Secretary of Defense has stated that he intends to include financial management reform among his top priorities. The Secretary faces a monumental task in putting in place such a fundamental reform. The size and complexity of DOD's operations are unparalleled. DOD is not only responsible for an estimated $1 trillion in assets and liabilities, but also for supporting personnel on an estimated 500 bases in 137 countries and territories throughout the world. It has also estimated that it makes $24 billion in monthly disbursements, and that in a given fiscal year, the department may have as many as 500 or more active appropriations. Given the unparalleled nature of DOD's operations, combined with its deeply entrenched financial management weaknesses, it will not be possible to fully resolve these problems overnight. Changing how DOD carries out its financial management operations is going to be tough work.

Going forward, various approaches could be used to address the underlying causes of DOD's financial management challenges. But, consistent with our previous testimony before your subcommittee, as well as the results of our survey of world-class financial management organizations and other recent reviews,[17] there are several elements that will be key to any successful approach to reform

- address the department's financial management challenges as part of a comprehensive, integrated, DOD-wide business process reform;
- provide for active leadership by the Secretary of Defense and resource control to implement needed financial management reforms;
- establish clear lines of responsibility, authority, and accountability for such reform tied to the Secretary;
- incorporate results-oriented performance measures tied to financial management reforms;
- provide appropriate incentives or consequences for action or inaction;

[17] *Department of Defense: Progress in Financial Management Reform* (GAO/T-AIMD/NSIAD-00-163, May 9, 2001) and *Executive Guide: Creating Value Through World-class Financial Management* (GAO/AIMD-00-134, April 2000).

- establish an enterprisewide architecture to guide and direct financial management modernization investments; and

- ensure effective oversight and monitoring.

Integrated business process reform strategy. As we have reported in the past,[18] establishing the right goal is essential for success. Central to effectively addressing DOD's financial management problems will be the recognition that they cannot be addressed in an isolated or piecemeal fashion separate from the other major management challenges and high-risk areas facing the department.[19] Successfully reengineering the department's processes supporting its business operations will be critical if DOD is to effectively address deep-rooted organizational emphasis on maintaining "business as usual" across the department.

Financial management is a crosscutting issue that affects virtually all of DOD's business processes. For example, improving its financial management operations so that they can produce useful, reliable, and timely cost information will be essential if the department is to effectively measure its progress toward achieving many key outcomes and goals across virtually the entire spectrum of DOD's business operations. At the same time, the department's financial management problems—and, most importantly, the keys to their resolution--are deeply rooted in and dependent upon developing solutions to a wide variety of management problems across DOD's various organizations and business functions. The department has reported that an estimated 80 percent of the data needed for sound financial management comes from the department's other business operations, such as its acquisition and logistics communities. DOD's vast array of costly, non-integrated, duplicate, inefficient financial management systems is reflective of the lack of an enterprise wide, integrated approach to addressing its management challenges. DOD has acknowledged that one of the reasons for the lack of clarity in its reporting under the GPRA was that most of the program outcomes the department is striving to achieve are interrelated.

Active leadership and resource control. The department's successful Year 2000 effort illustrated and our survey of leading financial management organizations[20] captured the importance of strong leadership from top management. As we have stated many times before, strong, sustained executive leadership is critical to changing a deeply rooted corporate culture—such as the existing "business as usual" culture at DOD--and successfully implementing financial management reform. The personal, active involvement of the Deputy Secretary of Defense played an important role in building

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[18]GAO/T-AIMD/NSIAD-00-163.

[19]As discussed previously, the eight interrelated areas that represent the greatest challenge to DOD developing world-class operations supporting its forces are: strategic planning, human capital, financial management, information technology, acquisition, contract management, support infrastructure, and logistics.

[20]*Executive Guide: Creating Value Through World-class Financial Management (GAO/AIMD-00-134, Apr. 2000).*

entity wide support for the department's Year 2000 initiatives. Given the long-standing and deeply entrenched nature of the department's financial management problems combined with the numerous competing DOD organizations, each operating with varying and often parochial views and incentives, such visible, sustained top-level leadership will be critical.

Clear lines of responsibility and accountability. Establishing clear lines of responsibility, decision-making authority, and resource control for actions across the department tied to the Secretary will also be a key to reform. As we reported[21] with respect to the department's implementation of its DRI, such an accountability structure should emanate from the highest levels and include the secretaries of each of the military services as well as heads of the department's various business areas.

Results-oriented performance. As discussed in our report on DOD's major performance and accountability challenges,[22] establishing a results-orientation will be another key element of any approach to reform. Such an orientation should draw upon results that could be achieved through commercial best practices, including outsourcing and shared servicing concepts. Personnel throughout the department must share the common goal of establishing financial management operations that not only produce financial statements that can withstand the test of an audit but, more importantly, also routinely generate useful, reliable, and timely financial information for day-to-day management purposes.

In addition, we have previously testified[23] that DOD's financial management improvement efforts should be measured against an overall goal of effectively supporting DOD's basic business processes, including appropriately considering related business process system interrelationships, rather than determining system-by-system compliance. Such a results-oriented focus is also consistent with an important lesson learned from the department's Year 2000 experience. DOD's initial Year 2000 focus was geared toward ensuring compliance on a system-by-system basis and did not appropriately consider the interrelationship of systems and business areas across the department. It was not until the department shifted to a core mission and function review approach that it was able to achieve the desired result--greatly reducing its Year 2000 risk.

Incentives and consequences. Another key to breaking down parochial interests and stovepiped approaches that have plagued previous reform efforts will be establishing mechanisms to reward organizations and individuals for behaviors that comply with DOD-wide and congressional goals. Such mechanisms should provide appropriate incentives and penalties to motivate decisionmakers to initiate and implement efforts that result in fundamentally reformed financial management operations.

Enterprise architecture. Establishing an enterprise wide financial management architecture will be essential for the department to effectively manage its large, complex

[21]GAO/NSIAD-00-72.
[22]GAO-01-244.
[23]GAO/T-AIMD/NSIAD-00-163.

system modernization effort now underway. As we testified last year,[24] the Clinger-Cohen Act requires agencies to develop and maintain an integrated system architecture. Such an architecture can help ensure that the department invests only in integrated, enterprise wide business system solutions, and conversely, will help move resources away from non-value added legacy business systems and nonintegrated business system development efforts. In addition, without an architecture, DOD runs the serious risk that its system efforts will result in perpetuating the existing system environment that suffers from systems duplication, limited interoperability, and unnecessarily costly operations and maintenance. In a soon to be issued report, we point out that DOD lacks a financial management enterprise architecture to guide and constrain the billions of dollars it plans to spend to modernize its financial management operations and systems.

Monitoring and oversight. Ensuring effective monitoring and oversight of progress will also be a key to bringing about effective implementation of the department's financial management and related business process reform. We have previously testified[25] that periodic reporting of status information to OMB, the Congress, and the audit community was another key lesson learned from the department's successful effort to address its Year 2000 challenge. Finally, this Subcommittee's annual oversight hearings, as well the active interest and involvement of other cognizant Defense committees, will continue to be key to effectively achieving and sustaining DOD's financial management and related business process reform milestones and goals.

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In closing, while DOD has made incremental improvement, it has a long way to go to address its long-standing, serious financial management weaknesses as part of a comprehensive, integrated reform of the department's business support operations. Such an overhaul must include not only DOD's financial management and other management challenges, but also its high-risk areas of information technology and human capital management. Personnel throughout the department must share the common goal of reforming the department's business support structure.

The transition to modern performance management and, along with it, to strategic human capital and information technology management, will require a cultural transformation throughout the department that will take time. DOD will need to be more partnerial, results oriented, integrated, and externally focused in the future. Without reengineering, DOD will have little chance of radically improving its existing cumbersome and bureaucratic processes. Such a fundamental reform will require sustained commitment from the highest levels of DOD leadership and changes throughout all levels of the department as well as vigorous congressional oversight. We stand ready to help the Congress and the administration put in place world-class business operations in support of our forces by providing professional, objective, and constructive assistance.

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[24] GAO/T-AIMD/NSIAD-00-163.
[25] GAO-01-244.

Mr. Chairman, this concludes my statement. I will be happy to respond to any questions you or other members of the Subcommittee may have.

(192012)

Mr. HORN. Our next speaker is Robert J. Lieberman, Deputy Inspector General of the U.S. Department of Defense.

Mr. Lieberman.

Mr. LIEBERMAN. Thank you. I appreciate the opportunity to be here once again to discuss this significant challenge with the subcommittee.

First, to summarize the results of the audit of major DOD financial statements for fiscal year 2000, I must report, unfortunately, that the extensive and costly DOD efforts to compile an audit of the fiscal year 2000 financial statements did not overcome the impediments caused by poor systems and unreliable documentation of transactions and assets. We were, therefore, unable to issue audit opinions on the Department-wide funds, or on all but one of the major subsidiary funds.

My written testimony describes some examples of the numerous problems in these year-end statements. I will just highlight two of them that I think are illustrative.

First, Department-level accounting adjustment entries used to compile the financial statements totaled $4.5 trillion, at least $1.1 trillion worth of which were unsupported by reliable explanatory information for the audit entries. This is somewhat of an improvement from last year, but remains a good indication of the need for wholesale changes to the financial data reporting systems.

Another example pertains to the reporting of estimated liabilities for environmental costs, basically clean-up costs. The estimate of $63.2 billion for environmental liabilities could not be verified and is obviously badly understated. Last year, the Department reported $79.7 billion of liabilities for that category of cost and agreed with us that that figure was understated by several tens of billions of dollars. Yet it went down this year.

Further compounding the problem, the financial statements that we were given to audit in December had a figure of $52.2 billion. No one could explain how they got from $52.2 billion to the $63.2 billion that was ultimately sent to OMB.

So this demonstrates a number of problems and difficulties in collecting information to put together credible environmental cost estimates in the first place, and then difficulties in compiling those estimates and getting them into financial statements in a timely manner to be audited.

A listing of the financial audit reports issued thus far in the current fiscal year is attached to my statement. Most pertain to financial statements, and they describe dozens more similar problems in financial reporting.

During the past year, DOD made some progress in addressing major impediments to favorable audit opinions, but the pace of overall improvement remains disappointingly slow. The level of frustration is high. Although the DOD has put a full decade of effort into improving its financial reporting, it seems that everyone involved, from Congress and the OMB to the audit community and DOD managers, have been unable to determine or clearly articulate exactly how much progress has been made and how far we still have to go.

In my view, this is at least partially caused by the emphasis on overall audit opinions for the year-end statements, as opposed to focusing on the status of individual system modernization projects.

The DOD has been working to identify and evaluate critical systems against Federal financial management requirements and accounting standards. Although it would be unfair to characterize this vital system's improvement effort as futile, progress has been very slow.

To facilitate oversight, and because of the successful results of the Defense-wide Y2K initiatives, 2 years ago we recommended that the DOD apply the same general management approach in bringing its systems into compliance with Federal financial management requirements. The Under Secretary of Defense—Comptroller—formally put into place such a process in January 2001 to implement that recommendation. We believe this initiative is really important and offers by far the best hope for more effective management of this crucial activity. We realize that the incoming Defense financial managers may wish to alter various details, but we hope that the basic approach will be followed, because we know it works.

The Y2K approach is completely compatible with the notion of holding Defense officials accountable by considering the DOD financial management improvement plan to be, in effect, a contract between the Department, the Congress, and OMB. The plan offers a potentially excellent vehicle for displaying the relevant performance goals and specific progress against those goals.

Each iteration of the plan has been more informative, but it remains a one-time status report, rather than a management tool that is actually used for management oversight. In addition, there are major problems with its accuracy, as described in our March 19, 2001, audit report and summarized in my written statement.

For the committee's benefit, I would like to underscore that, according to the plan, it will cost about $3.7 billion to make the critical reporting systems compliant with standards by 2003. This huge figure does not appear anywhere in the plan, but can be derived by adding up 167 individual system cost estimates. Its size illustrates both the scope of the remaining challenge and the need to treat CFO compliance as a very large Defense program or project needing strong management controls and oversight.

We believe, incidentally, that the $3.7 billion figure is significantly understated.

In any event, success or failure in the systems modernization and compliance effort will determine whether DOD ever achieves accurate financial reporting, both at year end and during the year, whenever managers need financial information.

This concludes my verbal statement.

Mr. HORN. Thank you. You have been very dedicated with the studies we have here. We will get into that soon.

[The prepared statement of Mr. Lieberman follows:]

HOLD FOR RELEASE
EXPECTED 10:00 A.M.
MAY 8, 2001

STATEMENT

BY

ROBERT J. LIEBERMAN

DEPUTY INSPECTOR GENERAL

DEPARTMENT OF DEFENSE

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT EFFICIENCY,
FINANCIAL MANAGEMENT, AND
INTERGOVERNMENTAL RELATIONS
HOUSE COMMITTEE ON GOVERNMENT REFORM

ON

DEFENSE FINANCIAL MANAGEMENT

MAY 8, 2001

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to be here today to discuss the significant challenges facing the Department of Defense (DoD) in financial management and the progress made in the year since your last hearing on these matters.

Financial Reporting for FY 2000

For FY 2000, the DoD Components' financial statements reported total assets of $616 billion, total liabilities of $1.0 trillion, total net costs of operations of $347 billion, and total budgetary resources of $656 billion. The extensive DoD efforts to compile and audit the FY 2000 financial statements, for the Department as a whole and for the 10 subsidiary reporting entities like the Army, Navy and Air Force General Funds, could not overcome the impediments caused by poor systems and unreliable documentation of transactions and assets. We were able to issue a clean audit opinion for the Military Retirement Fund, but disclaimers were necessary for all other major funds, including the DoD-wide consolidated statements. Some examples of the problems in these year-end statements follow.

Department-level accounting adjustment entries used to compile the financial statements were $4.4 trillion, with $1.1 trillion

of those unsupported by reliable explanatory information and audit trails. This is an improvement from FY 1999, when $7.6 trillion of adjustments were made with $2.3 trillion unsupported, but remains a good indication of the need for wholesale changes to the financial data reporting systems.

Outpatient medical care services data for the year-end statements were materially flawed. These data represent $86 billion of the reported $192.4 billion of military retirement health benefits liability. Further, questionable demographic data provided to the DoD actuary caused us to have additional concerns about the accuracy of the total liability estimate. As a result of recent legislation that expands the medical benefits for military retirees, this liability is expected to more than double by 2003 and the importance of recognizing this cost exposure has greatly increased.

The estimate of $63.2 billion for environmental liabilities could not be verified. The unsupported increases and decreases in the environmental liability estimate from year to year (for FY 1999 it was $79.7 billion) underscore the unreliability of the cumulative year-end reports.

We were unable to verify the $112.5 billion reported as the value of general property, plant, and equipment on the balance sheet.

DoD lacks supporting documentation for the reported value of many of its 800,000 individual items of real property, mostly buildings.

Accurate reporting of inventory and property remains a continuing challenge for each of the Military Departments and Defense Logistics Agency because of problems in logistics and other feeder systems. For example, the Defense Logistics Agency supply inventory value of $7.2 billion was unreliable because of pricing data problems, and the reported fuel inventory value of $3.2 billion was unreliable because of untimely completion and reconciliation of inventories, as well as untimely posting of transactions.

During the past year, the DoD made some progress in addressing major impediments to favorable audit opinions, but the pace of improvement is slow. The Department has many complex ongoing corrective actions under way to improve the accuracy of data and address every one of the issues discussed above, and we look forward to the new ideas of the incoming Comptroller leadership on what more can be done. We are participating in almost every one of the current improvement efforts and the DoD internal audit community has an excellent working relationship with the Department on these matters.

Nevertheless, the level of frustration is high. Although the DoD has put a full decade of effort into improving its financial reporting, it seems that everyone involved--the Congress, the Office of Management and Budget, the audit community, and DoD managers--have been unable to determine or clearly articulate exactly how much progress has been made. In my view, this is at least partially caused by the emphasis on overall audit opinions for the year-end statements, as opposed to focus on the status of individual system modernization projects.

Financial and Feeder Systems Compliance Process

Throughout the 1990's and again in 2000, the DoD attempted to compile year-end financial statements, despite the fact that it lacks systems capable of producing auditable results. Using convoluted, makeshift processes for transferring data from non-financial feeder systems, and making several trillion dollars' worth of accounting adjustments to transfer data into prescribed formats each year, the DoD has expended tremendous time and effort in futile attempts to compile auditable year-end financial statements.

The DoD also has been working to identify and evaluate all finance, accounting, and feeder systems against Federal financial management requirements and Federal accounting standards to identify specific system deficiencies. Although it would be

unfair to characterize this vital systems improvement effort as futile, progress has been slow. Because of the successful results of DoD Y2K initiatives, two years ago we recommended that DoD apply the same general management approach to bringing its systems into compliance with Federal financial management systems requirements. The Under Secretary of Defense (Comptroller) formally put into place the Financial and Feeder Systems Compliance Process in January 2001 to oversee and monitor the DoD Components' efforts to develop and modify critical systems. We believe this initiative is important and offers the best hope for more effective management of this crucial activity. We realize that the incoming financial managers may wish to alter various details, but we hope that the basic approach will be followed.

If DoD is able to achieve success in the Financial and Feeder Systems Compliance Process, more useful financial data will start to flow to Defense managers as each system achieves compliance. These improvements can and should occur years prior to the Department achieving clean audit opinions. I believe this is the correct course to follow because it properly places achieving useful financial information ahead of achieving clean audit opinions.

Financial Management Improvement Plan

The DoD Financial Management Improvement Plan offers a potentially excellent vehicle for displaying the relevant performance goals and progress against those goals. Each iteration of the Plan has been more informative, but it remains a one-time status report rather than a management tool that is actually used for management oversight. In addition, there are problems with its accuracy.

We reported in March that the latest Plan still did not contain a complete inventory of financial management systems. DoD needs to first map the flow of data from transaction origination point to presentation on the financial statements to ensure identification of all systems involved with processing financial data. The new DoD Financial and Feeder Systems Compliance Process requires that this mapping be done.

This year, DoD reported in the Plan that 19 of the 167 systems were compliant with Federal Financial Management Systems requirements. We found, however, that at least 12 of the systems either were not compliant or the reported compliance status was based on questionable support.

According to the Plan, it will cost about $3.7 billion to make the critical reporting systems compliant with standards by 2003.

However, we noted that many systems lacked any cost estimate for corrective action, there is no process to validate the cost estimates, and it is uncertain that all systems have been identified. Therefore the actual total cost could be considerably higher.

We also doubt that the Department can successfully manage the retirements, replacements, and upgrades for 167 systems by 2003 as shown in the Plan. We believe that 2003 is an overly optimistic forecast. Meeting information technology system development schedules is frequently a problem in both the public and private sectors; the DoD is no exception. In any event, success or failure in the systems compliance effort will determine whether DoD ever achieves accurate financial reporting, both at year-end and during the year whenever managers need information.

Conclusion

The DoD continues to face a wide array of financial management challenges. I have concentrated on financial reporting today because most of our audits have addressed that aspect. However, the Department also has compelling challenges in achieving better integration of financial management and other management functions and in improving finance operations.

We look forward to working with the new Administration on the Department's financial management challenges. We very much appreciate the Subcommittee's interest in these matters as well.

A list of our financial audit reports from FY 2001 to date is attached.

Attachment

Examples of FY 2001 Inspector General, DoD
Reports on Financial Management

2001-110	Defense Health Program Funds Administered as Part of the TRICARE Program dated April 30, 2001
2001-109	DoD Payroll Withholding Data for FY 2000 dated April 27, 2001
2001-108	Recognition of Revenues and Expenses in the Defense Business Management System dated April 27, 2001
2001-99	Use of Contract Authority for Distribution Depots by the Defense Logistics Agency dated April 16, 2001
2001-97	Preparing Financial Reports for Marine Corps Appropriations dated April 10, 2001
2001-85	The 2000 DoD Financial Management Improvement Plan dated March 19, 2001
2001-81	Financial Reporting at the Washington Headquarters Service dated March 15, 2001
2001-79	Inventory Valuation at the Defense Supply Center Richmond dated March 14, 2001
2001-78	Inventory Valuation at the Defense Supply Center Columbus dated March 14, 2001
2001-71	Navy Financial Reporting of Government-Owned Materials Held by Commercial Shipyard Contractors dated March 2, 2001
2001-70	Internal Controls and Compliance with Laws and Regulations for the DoD Agency-Wide Financial Statements for FY 2000 dated February 28, 2001
2001-68	Inspector General, DoD, Oversight of the Audit of the FY 2000 Military Retirement Fund Financial Statements dated February 28, 2000
2001-67	Inspector General, DoD, Oversight of the Army Audit Agency Audit of the FY 2000 U.S. Army Corps of Engineers, Civil Works Program, Financial Statements dated February 28, 2001
2001-64	Inspector General, DoD, Oversight of the Army Audit Agency Audit of the Fiscal Year 2000 Army General Fund Financial Statements dated February 28, 2001
2001-63	Inspector General, DoD, Oversight of the Army Audit Agency Audit of the FY 2000 Army Working Capital Fund Financial Statements dated February 28, 2001

2001-62	Inspector General, DoD, Oversight of the Air Force Audit Agency Audit of the FY 2000 Air Force Working Capital Fund Financial Statements dated February 28, 2001
2001-60	Internal Controls and Compliance with Laws and Regulations for the FY 2000 Financial Statements for Other Defense Organizations - General Funds dated February 28, 2001
2001-58	Inspector General, DoD, Oversight of the Air Force Audit Agency Audit of the FY 2000 Air Force General Fund Financial Statements dated February 21, 2001
2001-57	Inspector General, DoD, Oversight of the Naval Audit of the FY 2000 Navy Working Capital Fund Financial Statements dated February 21, 2001
2001-56	Inspector General, DoD, Oversight of the Naval Audit Service Audit of the FY 2000 Department of the Navy General Fund Financial Statements dated February 21, 2001
2001-49	Abnormal General Ledger Account Balances for Other Defense Organizations Reported by DFAS Cleveland dated February 13, 2001
2001-48	Financial Reporting for Other Defense Organizations at the Defense Agency Financial Services Accounting Office dated February 9, 2001
2001-42	Accounting and Disclosing Intragovernmental Transactions on the DoD Agency-Wide Financial Statement dated January 31, 2001
2001-41	Journal Entries to Support Departmental Reporting for the Marine Corps dated January 31, 2001
2001-39	Financial Reporting of Department 97-Funded Property, Plant, and Equipment dated January 30, 2001
2001-30	Oversight of Defense Finance and Accounting Service Corporate Database Development dated December 28, 2000
2001-26	Accuracy of the Government-Owned Contractor-Occupied Real Property in the Military Departments' Real Property Databases dated December 22, 2000
2001-14	Development and Implementation of a Joint Ammunition System dated December 6, 2000
2000-11	Prior Period Adjustment to Remove National Defense Property, Plant, and Equipment from the DoD Agency-Wide Balance Sheet dated November 16, 2000

The reports are available on the Web at www.dodig.osd.mil/audit/reports

Mr. HORN. Our next witness is from the Department of Defense, Mr. Lawrence J. Lanzillotta, the Principal Deputy and Deputy Under Secretary for Management Reform in the Department of Defense.

We are glad to have you here.

Mr. LANZILLOTTA. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, it is my pleasure to be here to discuss financial management within the Department of Defense.

Let me begin by stating that financial management reform is one of Secretary Rumsfeld's top priorities, as he reflected in several major actions he has already undertaken.

Shortly after being confirmed, he initiated a study of the Department's financial operations, to include an examination of initiatives under way or planned. The Secretary has begun assembling a senior leadership team that is committed to financial management reform across the Department, and he has recognized the Comptroller's office and established Deputy Under Secretary positions to focus more on financial management reform and on management initiatives.

Additionally, Dr. Zakheim, the recently confirmed Under Secretary-Comptroller, stated during his confirmation hearing that financial management reform is his top priority.

The reorganization of the Comptroller's office established my position as the Principal Deputy to the Comptroller and the Deputy Under Secretary for Management Reform. It also established a new Deputy Under Secretary who will specifically focus on financial management issues, Ms. Tina Jonas, and another Deputy Under Secretary who will focus on program budget issues, Mr. Wayne Schroeder.

As Principal Deputy and Deputy Under Secretary for Management Reform for the Department, I give you my personal assurance that reforming financial management within the Department of Defense is my top priority.

Mr. Chairman, from the top down, the Secretary has in place a cadre of leaders who are committed to improving financial management within the Department.

It is Secretary Rumsfeld's intent to obtain timely and accurate information as a routine matter of business. We have world-class armed forces. We intend to achieve world-class financial management.

Accurate and timely management information is the lifeblood of successful management decisions. Managers across the Department require accurate and timely information on the cost of operations and programs if they are to achieve the most effective use of taxpayers' dollars.

The Department must have processes and systems that do more than prepare accurate financial statements once a year. The Department's management processes must be able to provide managers with current, reliable, and relevant information to facilitate sound decisionmaking.

The most critical step in the Department's effort to produce timely and reliable financial management information and to produce auditable financial statements is having, within a coherent archi-

tecture, compliant financial management systems and associated feeder systems—such as inventory, logistics, property, and medical—that provide the majority of the Department's financial information.

The lack of integrated systems, both financial and nonfinancial systems, has been a major contributor to the Department's inability to produce such information. Without systems that comply with prevailing Federal accounting standards, the Department would not be able to produce reliable financial statements on a timely and consistent basis.

Over the past decade, the Department has implemented a number of improvements to consolidate and overhaul financial management processes. Financial operations have been consolidated, the number of non-compliant financial accounting systems has been significantly reduced, and standard systems have been designated. Nonetheless, much remains to be done.

The Congress and the American people must have full confidence that the Department maintains the very highest standards in managing the Department. Secretary Rumsfeld is a proven industry leader who is focusing on Department-wide management reform. We have to improve our management information and financial management processes. Financial management reform is part of a much larger Department-wide management reform initiative. Business practices will be reengineered to adopt best practices from both the private and government sector.

The Department is in the process of transforming our Defense forces to meet the challenges of the 21st century. We must also transform our management processes. As with any major Department of Defense transformation initiative, we will need widespread support from the Congress and other governmental agencies to achieve our shared goal. Transforming management processes will allow the Department to obtain more timely and better information to enable our Defense leaders to make more informed management decisions.

In closing, Mr. Chairman, I would like to thank you and the committee for providing me this opportunity to address financial management reform and management reform within the Department. Thank you.

Mr. HORN. Thank you very much for the statement.

[The prepared statement of Mr. Lanzillotta follows:]

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House Committee on
Government Reform

STATEMENT OF MR. LAWRENCE J. LANZILLOTTA

PRINCIPAL DEPUTY AND DEPUTY UNDER SECRETARY FOR MANAGEMENT REFORM

DEPARTMENT OF DEFENSE

BEFORE THE

HOUSE COMMITTEE ON GOVERNMENT REFORM

SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS

ON

FINANCIAL MANAGEMENT WITHIN THE DEPARTMENT OF DEFENSE

May 8, 2001

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House Committee on
Government Reform

Statement of Mr. Lawrence J. Lanzillotta
Department of Defense
Principal Deputy and Deputy Under Secretary for Management Reform
Before the House Committee on Government Reform
Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations
May 8, 2001

Mr. Chairman and Members of the Committee, it is a pleasure to be here to discuss financial management within the Department of Defense.

LEADERSHIP COMMITTMENT

Let me begin by stating that financial management reform is one of Secretary Rumsfeld's top priorities, as reflected in several major actions he has already taken. Shortly after being confirmed, he initiated a study of the Department's financial operations, to include an examination of initiatives underway or planned. The Secretary has begun assembling a senior leadership team that is committed to financial management reform across the Department. And he has reorganized the Comptroller's office and established Deputy Under Secretary positions to focus more on financial management reform and on management initiatives. Additionally, Dr. Zakheim, the recently confirmed Under Secretary of Defense (Comptroller), stated during his confirmation hearing that financial management reform is his top priority.

The reorganization of the Comptroller's office established my position as Principal Deputy to the Comptroller and Deputy Under Secretary for Management Reform. It also established a new Deputy Under Secretary who will specifically focus on financial management issues, and another Deputy Under Secretary who will focus on program budget issues.

As Principal Deputy and Deputy Under Secretary for Management Reform for the Department, I give you my personal assurance that reforming financial management within the Department is also my top priority. Mr. Chairman, from the top down, the Secretary has in place a cadre of leaders who are committed to improving financial management within the Department.

It is Secretary Rumsfeld's intent to obtain timely and accurate information as a routine matter of business. We have world-class armed forces; we intend to achieve world-class financial management.

CHALLENGE

Accurate and timely management information is the lifeblood of successful management decisions. Managers across the Department require accurate and timely information on the costs of operations and programs if they are to achieve the most effective use of taxpayers' dollars. The Department must have processes and systems that do more than prepare accurate financial

statements once a year. The Department's management processes must be able to provide managers with current, reliable and relevant information to facilitate sound decision-making.

The most critical step in the Department's effort to produce timely and reliable financial management information and to produce auditable financial statements is having, within a coherent architecture, compliant financial management systems--and the associated feeder systems (such as inventory, logistics, property, medical, etc.) that provide the majority of the Department's financial information. The lack of integrated systems--both financial and nonfinancial systems--has been a major contributor to the Department's inability to produce such information. Without systems that comply with prevailing federal accounting standards, the Department would not be able to produce reliable financial statements on a timely and consistent basis.

Over the past decade, the Department has implemented a number of improvements to consolidate and overhaul financial management processes. Financial operations have been consolidated, the number of noncompliant finance and accounting systems has been significantly reduced, and standard systems have been designated. Nonetheless, much remains to be done.

The Congress and the American people must have full confidence that the Department maintains the very highest standards in managing the Department. Secretary Rumsfeld is a proven industry leader who is focusing on Department-wide management reform. We have to improve our management information and financial management processes. Financial management reform is part of a much larger Department-wide management reform initiative. Business practices are being reengineered to adopt best practices from both the private and government sector.

CLOSING

The Department is in the process of transforming our defense forces to meet the challenges of the 21st century; we must also transform our management processes.

As with any major Department of Defense transformation initiative, we will need widespread support from the Congress and other governmental agencies to achieve our shared goals. Transforming management processes will allow the Department to obtain more timely and better information to enable our Defense leaders to make more informed management decisions.

In closing, Mr. Chairman, I would like to thank you and the Committee Members for providing me this opportunity to address financial management reform within the Department of Defense.

Mr. HORN. Now we go to questions. We will alternate with Members here. I will start with the first 5 minutes, and the ranking member will have 5 minutes, and then we will go back and forth. If others come in, they will have their crack at it.

Mr. Kutz, what you said is very well taken. We have a new Secretary in place. I, for one, have a lot of good impressions of the Secretary. I have known him for 30 years. If anybody turns that place around, it will be Don Rumsfeld.

The question I would like to hear, to just get out here and see if we are on the same wave length, you just sort of isolate, what is the essence of the first three things on the financial side and what are the first three things on the management side that really ultimately relate to the management side?

What is your first three? Then I want to see if Mr. Lieberman and Mr. Lanzillotta agree with that.

Mr. KUTZ. On the financial side, we have a combination of issues: people, processes, and financial systems. My statement has examples of both people and processes that were not working properly.

The Department has policies and procedures that are not being followed. That is something that can be fixed without a long-term system reform. That is something that can be done in the short-term.

The other major issue besides the people and processes involves the financial management systems. That is where Mr. Lanzillotta mentioned an enterprise architecture is needed to make sure that all of DOD's decentralized and in some cases duplicative systems efforts that are going on will, at the end of the day, work toward a system that will give the Department world-class financial management.

So it is the people, processes, and systems on the financial side. On the other side, we have the logistics, and some of the examples I mentioned earlier included inventory problems, which ties very closely to financial management. We also have the acquisition process challenges with respect to contracts and the payment of contracts, the management of contracts, etc.

I would also say that computer security is another important challenge that is closely linked to financial management and has lots of issues beyond efficiency. It is a security of data issue that needs to be addressed.

Mr. HORN. Mr. Lieberman, do you agree with that list, or would you add a few things to it?

Mr. LIEBERMAN. I would add a few things to it.

To a significant degree, as mentioned in my written and oral statements, the system modernization effort is the key to this whole thing. But, beyond that, I think that we need to run this whole effort as a program. I don't feel that it has ever really been run like a program with explicit goals and measurements.

We all know what the end state goal is: auditable financial statements and useful financial information. But the myriad of milestones, including interim milestones that are normally tracked in a complicated program, have been very hard to nail down over the years. I think we have gone far too long with too little structure in this whole process.

Third, we are spending a lot of money on this process. I believe the Department needs to revisit its priorities in terms of where it puts its resources for corrective action.

I thoroughly agree with the GAO's point that extraordinary efforts to put together financial statements will ultimately probably fail anyway and do nothing to fix the underlying systems problems, and should not be our highest priority. It is not the best way to spend DOD money.

Last, I believe that the human factor here is very important. I think a lot of the problems we are talking about are management problems for the defense finance and accounting community in particular, but DOD as a whole has lots of workforce issues in terms of drastically downsized organizations that cannot keep up with their current workload, promises of process redesign to decrease workload that have not quite come true, and major training challenges. Each and every individual involved with these processes can do a better job in the first place so we are not continually trying to reconcile records that do not match and doing things the hard way, retroactively, rather than doing it right the first time.

Mr. HORN. Mr. Lanzillotta, what do you think? What would you add to it?

Mr. LANZILLOTTA. I don't know if I would disagree with anything that they have said. I think I would look at it in a slightly different way. I think the Department has a lot of these problems that they mentioned, but they all have to be addressed. I don't know if we can sit down and have the luxury to say we will take care of the top three now and go to the next three.

In looking at that, we have already had some discussions prior, not for this hearing but in the past. But I'm looking more—we have a plan. We just need to upgrade our plan. We need to get the system architecture and get all the requirements for these systems together for modernization.

We just cannot concentrate on one or two systems right now. We have to get a whole plan that shows where every one of these systems interact on the financial management and management information process. We have to identify more specific milestones. That way, we can measure our progress, not just for the auditors to come and measure the progress or people to come in and see but for our management in the Department of Defense. They need to know—the first responsibility is to them, our defense leaders. They need to know how we are doing on this.

We have to also do a better job, as mentioned, on identifying the resources it is going to take to fix this problem. This is not a Department of Defense problem; this is a shared problem with our government. We have to be up-front. We have to say, this is what the cost is for fixing this system. We have to develop measurable matrixes we can measure against on these.

Our plan has to have—and I agree with Mr. Lieberman. We might have some initial problems, as he is talking about, but it has to be measured overall. We have to have accountability. Somebody has to be responsible for fixing this.

We have systems in stovepipes right now. We have to make sure they match. Then when somebody is developing their system, he has to have the authority to allow us to reengineer the practices

to make it work. We just cannot continue to do stovepipe development.

The last thing, I think Secretary Rumsfeld—the things are lining up now that we have the leadership to do a structural change—not only a structural change but a cultural change in the way the Department attacks these problems. I think that is key.

I don't know if I can say, well, we just want to reestimate our environmental liability and then look at another problem, asset accountability. I think we are probably past that. I think we are to the point now that it just has to be done. I don't want to quibble with any of the comments on initial things or little facts. I think it is just time for us to step up to the plate.

Mr. HORN. As I usually find out, the question period is too short, so the gentlewoman from Illinois will have 10 minutes, and then Mr. Putnam, who has come, he will have 10 minutes.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman.

Let me ask first—in my opening statement, I said that the DOD Inspector General testified in 1995 that by 2000 there would be this turnaround; and now, Mr. Lieberman, the word is that by the middle of the decade that there may be financial statements that could be audited.

Though we have heard the magnitude of the problem, why is it it would take that long? Do you expect that is the time you are projecting?

Mr. LIEBERMAN. I don't remember exactly who gave that testimony, but I wrote it. At the time, we were severely criticized for being pessimists, and we were labeled as defeatists. As it turns out, we were wrong, because it took even longer than the 5 years we were talking about back then.

The problem here is this large number of automated systems that compile data on millions and millions of various kinds of transactions that have financial implications, and all of this has to be crunched together. The typical corporation can do that because they design an integrated information technology construct in the first place. Defense did not have that in place, and developing new systems is a slow process in the best of circumstances. It always takes several years.

I think, in retrospect, no one can deny that systems improvement was too slow in the decade of the 1990's. There are various reasons for that. One is resources. This has never been a popular thing to spend money on, and there was never a big push to do so.

Ms. SCHAKOWSKY. Are you saying there were insufficient resources in the Department on this?

Mr. LIEBERMAN. Yes. It was possibly the Department's own fault. They did not address it. Nobody ever knew what the projected cost of this effort was. It has only been since the Congress has required systems improvement cost estimates during the last 3 years that we have begun to get a handle on how big the cost of this really is.

Ms. SCHAKOWSKY. Are you saying that over the last 6 years there has been steady progress? Can we look back at the annual reports and say that, though it has been slow, we are getting there?

Mr. LIEBERMAN. There has been progress. I think it could have been a lot faster than it was. Resources are part of the problem.

Management commitment is part of the problem. To get all the parts in line to cooperate to do this has been a problem. It has been viewed as the accountants' challenge, and the rest of the Department has been very hard to capture in terms of getting on board.

Now, I think because of the fact that the Department itself agrees that it will take until at least 2003—and I think that is optimistic—to fix these systems, there simply is no way we are going to have credible financial statements until the systems are fixed. So I think the middle of this decade is probably a pretty good bet at this point for clean audit opinions.

Ms. SCHAKOWSKY. Mr. Kutz, the cultural thing in this, if there were an accountant from Mars who might look at the Department of Defense, they might think about the different branches of the Armed Forces and all the repetitive or duplicative things we do as being not the most efficient way to run a Department.

It says here, "These analyses can be narrowly focused, and do not consider joint acquisitions with other services." Is that the kind of resistance you are talking about, the kind of efficiency that might result from joint cooperation? How does one overcome these longstanding cultural problems?

Mr. KUTZ. This relates to the plan Mr. Lanzillotta mentioned. I think that is a good example of the reflection of the parochialism and narrowness of interest.

The financial management improvement plan is a very big improvement from the prior years' plan. It has a lot of data and a lot of good information. The problem is, however, the plan is not a management tool at this point. It is a reflection of a data call of all the different decentralized, stovepiped efforts that are going on out there. Without an actual plan from the top that is driven by someone in a senior management position, it is going to be very difficult to make the kind of long-term change in culture that we are talking about.

I will let Mr. Warren address the acquisition issue specifically.

Mr. WARREN. I would just add that, as you said, that is a perfect example. There is a real bias toward each service having their own individual system, rather than, as has been mentioned here today, an overall architecture which guides the management process of the Department.

What that ultimately means is that funds are spent for multiple systems, and they again, as has been said, often do not talk together, or do not provide the information and interchange, the information that is needed to provide not only financial management information but also management information that is needed for the day-to-day operation of other activities.

Weapons systems certainly is an area over time where that same phenomenon has occurred. There are various examples out there where multiple systems have been built that have similar capabilities, so that clearly is a problem.

I think at the heart of solving this—and, again, it has been mentioned by the other panelists—is getting central leadership, a top-level commitment that you are going to go to an integrated system. That person needs to have control of the resources to make that stick, so these multiple systems are not put into place.

Part of the reason that it occurs, quite simply, is because the services have the money to do it.

Ms. SCHAKOWSKY. You mentioned the issue of systems, weapons systems. I wanted to just ask you this. The issue of inventory control in the GAO's high-risk report, which was issued earlier this year—I was really shocked to learn that about half of DOD's $64 billion inventory exceeds war reserve or current operating requirements. Specifically, you cited a figure of $29.6 billion.

Let me ask you if you can elaborate on that. Are we getting desensitized to these huge numbers? Are you saying that DOD essentially bought $30 billion worth of equipment that it does not need? What are we going to do to correct this?

Mr. WARREN. Just to correct that, not that it necessarily does not need, but it did not need at the point in time that it bought it, based on its own requirements.

Once the items are purchased and are in the inventory, then I think there is a very good argument to say that we need to take a look at this from an economic retention standpoint and decide, now that we have it, should we go ahead and retain some of it.

Ms. SCHAKOWSKY. I am concerned about the earlier decision.

Mr. WARREN. Correct. All things being equal, if they had accurate information in terms of forecast demands, in terms of systems that were ultimately going to become obsolete, those items would not have been purchased. Those are breakdowns in the systems and in management processes within the inventory management area.

That area has been on GAO's high-risk list since 1990. We have issued a number of reports on that area, as well as the Inspector General.

At the heart of that system is a need for business process reform. We have been advocating an overall logistics transformation plan that would guide not only the inventory piece but there are many other pieces: transportation, maintenance of major weapons systems, storage of items, disposal of items. These all go to make up the logistics expenditures.

We think there needs to be a comprehensive plan that deals with all of those issues. Again, as the other plan said, that needs to be tied into what you are going to do in your financial management area, so ultimately you come out and have an effective management system for all elements of the Department in your major business areas.

Ms. SCHAKOWSKY. Thank you.

Thank you, Mr. Chairman.

Mr. HORN. Let's pursue that just for a second before Mr. Putnam——

Does GAO say, why don't we just get one system in one place on one aspect and get all those services to do that?

Mr. WARREN. We would say that would be certainly one approach that could be used. In other words, we understand the enormous challenge that would be involved in putting the entire—or dealing with all of the various business functions at a single time.

Perhaps the approach would be to take one of your major business areas and come up with a model for success in terms of getting the results that you want, and then move forward and do that.

Perhaps financial management is the area to use in order to accomplish that.

But, in doing that, clearly whatever approach is used for that model has to be integrated so that the other elements of the business processes within the Department are in fact considered as those decisions are made.

Too often in the feeder systems that were mentioned, they will go on and make improvements, for example, in their inventory accounting or control processes, without taking into consideration the things that need to be done to provide accurate information to the financial community.

Mr. LIEBERMAN. If I can add one thing, Mr. Chairman.

Mr. HORN. Go ahead.

Mr. LIEBERMAN. We have talked for a whole hour about systems, and we have never mentioned the Chief Information Officer of the Department.

One of the problems that remains is that 5 years after the Clinger-Cophen Act the Department still has not effectively implemented that law and really established an information systems czar to help all these different functional communities come together.

Mr. HORN. Mr. Lanzillotta has to leave at 11:20. By the way, you are free to come back this afternoon, because if members have questions we can then do it, from 1:30 to 2:30.

What do you think of that idea of incrementalism, let us get one and get that done right? Who is the Chief Information Officer now? Is that in your bailiwick, or what?

Mr. LANZILLOTTA. Mr. Chairman, no, that does not fall within my responsibilities, although I recognize the need for such an office or somebody within the OSD comptroller to try to get a handle around all these financial management systems.

I do not disagree with the standardization of systems, but I don't want that to become the goal for the Department by itself. The goal is to have accurate and timely management information.

Now, when GM or a large corporation merges with another corporation, they don't necessarily make the new corporation conform to their system. They look at the systems and make sure that they can talk and that they are compliant.

I am not so much concerned with coming through and making sure that we have a standardized system that does one thing or another, as long as we have systems that prove accurate and timely and are compliant with financial regulations and that talk to each other. Then, as time goes on, we may come later and replace those systems with an integrated system.

I think the Department needs to focus to make sure that—we have to play the hand we are dealt. This is where we are. We don't have the luxury of going back and stopping in our repair part system, our inventory system, our health care system, or any of those systems, and say, OK, we are going to develop a single system, and we are going to take time to institute it and get everybody trained on it. We are playing the hand we are dealt.

Eventually, that is where we are going to go. But I think first we have to get everything compliant, and it has to meet our management objectives. Then we can turn around and, as we replace

those systems, maybe we can come to a more efficient system that is just one system for each category.

Mr. HORN. We will send you a few questions. I would like to start in the page right here on which management systems are you talking about. If you could just give us that.

Now, the gentleman from Florida, Mr. Putnam, will question you for 10 minutes.

Mr. PUTNAM. Thank you, Mr. Chairman.

What are your management objectives?

Mr. LANZILLOTTA. I think Secretary Rumsfeld has one focus. That focus is to provide, in the area of financial management—he has many focuses—but in the area of financial management I think that he wants clear, accurate, timely, compliant information when he wants it. I don't think he wants to wait until the end of the year to find out about how these systems are doing, or inventory, or anything else like that. He wants management information to make management decisions now.

The fact that we have a clean opinion is kind of a matrix. It is kind of a measurement on how well the systems are doing, but it is not the goal. I think Secretary Rumsfeld's goal and what he has charged the people to do is—to include myself—is to make sure that he has the management information, to know the cost of operations so when he is trying to make financial decisions on the readiness of his forces, he can do that.

Mr. PUTNAM. What will it cost to get to that system or that set of systems or that network of systems or that web of systems that would allow him to have clear, accurate, timely information at his fingertips at his request?

Mr. LANZILLOTTA. Sir, I guess after a week here I really don't have that information, and I don't know when I will. It's going to be terribly expensive, I know that. But it's kind of like, you know, we're starting and building the system architecture and mapping the data flow as it currently exists. We kind of have to take that to find out where our rough spots are to see where we need to devote some assets and make it work. I'm afraid if I gave you a dollar number, I know it would be absolutely wrong.

Mr. KUTZ. Congressman Putnam, the current amount being spent on systems at the Department is about $21 billion a year, which includes new systems development and legacy systems upkeep. I'm not sure exactly what the breakdown is between the two. But in many respects there is not a shortage of money going into IT. $21 billion is half of what the Federal Government is spending on IT; governmentwide it's about $44 billion. So it's a pretty substantial investment being made right now and we've seen minimal progress over the years.

Mr. PUTNAM. Was information technology logistics and those considerations, part of this tooth to tail review of Pentagon operations and strategy? Did that play any part whatsoever?

Mr. LANZILLOTTA. Yes, sir, I think does. I think that you know the creation of my position as management reform exists prior to me taking this position April 30th. And I think that's what the Secretary has in mind, is looking at that type of thing. You know, we have some of those things that are working now. For my sake I

hope there will be more in the future, and the Department has taken this very seriously.

Mr. PUTNAM. Thank you. Tell me perhaps for the GAO, or whomever, if you have an estimate on the amount of improper payments, duplicate payments, overpayments, payments made for goods and services not delivered that have been made by the Defense Department.

Mr. KUTZ. For fiscal year 2000 what I know is that about $900 million was repaid by contractors for overpayments. I don't believe though that the Department knows how many dollars of improper payments are made annually. No one knows in the Federal Government. There are estimates at certain departments, for example, the earned income tax credit.

Mr. PUTNAM. $900 million.

Mr. KUTZ. $900 million. But that's what they know. And much of that is for contractors that identified the overpayments and voluntarily sent them back versus the Department identifying overpayments and asking for them to be sent back.

Mr. PUTNAM. So that was the Good Samaritan refund?

Mr. KUTZ. Much of that would have been the Good Samaritan.

Mr. PUTNAM. Are some defense agencies performing more efficiently or producing better financial statements or financial instruments than other agencies? Who's performing at the top and who's performing at the bottom within the Department?

Mr. LIEBERMAN. Well, the Military Retirement Fund earned a clean audit opinion and that's been true for several years. So it's in the best shape in terms of the large reporting entities that make up the overall departmental financial statements.

Some defense agencies are doing better than others. The Defense Finance and Accounting Service itself got a clean opinion on its statements for fiscal year 2000. However, that organization is not that large in the overall DOD scheme of things. So these are significant steps forward, but they're not giant leaps forward.

Mr. PUTNAM. What process is in place now to identify these improper payments or overpayments?

Mr. KUTZ. At the Department—I'm not aware of what process they have to estimate what overpayments there are. There are controls intended to reduce overpayments that have been put in place. And I believe one of the areas of improvement has been the reduction in the amount of overpayments at DFAS from what it was several years ago.

Mr. LIEBERMAN. There is one area where there is definite progress on the systems front. A lot of the faulty payments problem is because of the outmoded systems that we use in the payment process as well as bad data in our systems. There is a system called MOCAS, the Mechanization of Contract Administration Services, horrible acronym, which has been our main data base for facilitating the payment of contractors for the last 20 years. It is being phased out now in favor of a new system, which should improve the efficiency of the payment process dramatically.

Mr. PUTNAM. Could you elaborate a little bit on what you described as the outmoded system?

Mr. LIEBERMAN. Well, MOCAS has 20-year-old technology. It is not efficiently interoperable with a lot of other systems.

Mr. PUTNAM. Hang on 1 second. How do you have a $21 billion information technology budget that is—but yet you still have a vendor system that is 20 years old and obsolete? How do you reconcile those two things?

Mr. LIEBERMAN. Well, the need to replace MOCAS was recognized several years ago and it takes several years to develop replacement systems. So the replacement system has been under development for the past several years and a good chunk of that annual IT budget goes into systems like that.

I think it's unfair for us to sit here and give the impression that DOD has not improved a lot of its systems over the past decade because it has. There are a lot of new systems coming online now whose developments started in the middle of the decade, for example, that are quantum improvements over what they're replacing.

Mr. PUTNAM. I think that the committee and the Congress recognize that nobody goes to work every day at the Pentagon thinking of ways to waste the taxpayers' money. But the budgets are so enormous and the scope is so broad and everything about what goes on in our Defense Department is by factors of 10 so much larger than any other portion of the government. And so it is rather frustrating when all of us hear about supply shortages or training and operations budgets that are going to be depleted by August 31, and yet we're spending half of what the entire Federal Government spends on information technology and nobody really can tell us, at least not through an auditor's eyeball, where it all went. And so there is a frustration out there.

And it doesn't mean that anybody is here to beat up on the Department of Defense or to beat up on the Pentagon. We certainly recognize that you have a very difficult job, and all of us want to support you in that effort. But good God almighty, $21 billion and we still can't pay our bills on time? I mean, there's a cause for concern there. And I think that's where the chairman is headed with this.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. HORN. Before Mr. Lanzillotta leaves let me ask this question of GAO. Mr. Kutz, GAO recently issued a report on the Department of Defense's inability to estimate the cost of removing unexploded ordnance from its training ranges. What do you believe the Department of Defense needs to do to determine the locations and extent of contamination and what it will cost to clean up the various Department of Defense training ranges?

Mr. KUTZ. The estimate that they have right now is about $14 billion in their financial statements, but there are estimates out there and these are DOD estimates also that could be over $100 billion. What they need to do is what the Department of Energy has done, is go through a disciplined process of inventorying and costing out what it takes to remediate the environmental issues.

I had some experience with Energy in looking at what they did in the mid-1990's and DOD is clearly years behind where Energy is in actually documenting and costing out what the issues are and giving the Congress a good idea of what it's going to cost for all of the remediation.

There is a report that they issued or they issue annually that talks about what's being funded today. But that is woefully less or

significantly less than what actually is going to have to be done at the Department. So this is potentially a $700 billion issue at DOD versus what Mr. Lieberman said earlier, the $60 or $80 billion that has been reported the last several years.

Mr. HORN. Well, on that point and whether it's a management tool or not, I can remember 3 years ago when we were talking about cruise missiles in the former Yugoslavia, Serbia, etc., and we were left absolutely speechless here. Now a couple of people knew that you didn't have the cruise missiles and you didn't have an assembly line from the Gulf war and all of that. We couldn't believe it. I just wonder when the Secretary wakes up in the morning does somebody give him an inventory on where we are on some of these key things that the country might have to use either in its own defense or anything else?

I'd like to know, can you explain the significance of the DOD not having the 62,000 missiles, rockets and other ammunition items in its records? Our understanding is that you can't really find what kind of missile is in there or not. Are we just being misled or what? What do you know about that, Mr. Lanzillotta.

Mr. LANZILLOTTA. Sir, I'll give you what I know about it. I think there's a difference between things that are lost in the financial records and things that are lost in the property accountability records. I think when you go down to the unit and on the property accountability you know they can tell and there's been other reports on spot reports of this that there is a 99 or some high percentage of accountability at that level.

The problem is our financial systems don't necessarily, because they're old and weren't originally meant to track that, can go back there and track that same data. And that's the problem. The guy knows down there where his missiles are and how many missiles he's got, but our financial systems need to be revamped, and that's part of the system's problem, to make sure that same information comes in.

Mr. KUTZ. The policies and procedures are there that the test facility in this case or the four test facilities were acquired by DOD's own policies to report these items into the central visibility records. They just told us they didn't do it.

Mr. LANZILLOTTA. There's just no excuse for that.

Mr. HORN. I agree. So I hope there will be a series of things that the Secretary of Defense, the Deputy Secretary, etc., all can know that this is what we've got as of this date. And certainly the CINCs that run a lot of the military things, they ought to have that on their desk in the morning. I wonder, Mr. Lieberman, as I remember, the environmental unit on the base closures is part of the Office of the Secretary of Defense. Have you ever done the Inspector General matter with them?

Mr. LIEBERMAN. Yes, indeed. We try to maintain a level of effort of several audits a year on the Department's environmental program. Many of those audits over the years have been requested by

that office. Others have been requested by Congress or are self-initiated. But I'd be happy to provide for the record a list of those reports going back over the last few years.

Mr. HORN. Well, and if you could send me the reports because my feeling is that's the slowest snail in the Pentagon.

[The information referred to follows:]

Inspector General, Department of Defense Audit Reports on Environmental Cleanup, Compliance, Conservation, Pollution Prevention, and Technology

D-2001-105 Implementation of National Defense Center for Environmental Excellence Projects (4/25/01)

D-2001-087 Defense Logistics Agency Wastewater Treatment Systems (3/26/01)

D-2001-025 Summary Report on DoD Hazardous Waste Disposal Costs (12/22/00)

D-2001-015 Defense Environmental Security Corporate Information Management Program (12/07/00)

D-2001-010 Navy Shipboard Pollution Control Equipment Program (11/14/00)

D-2001-009 DoD Compliance With Hazardous Waste Laws in the U.S. European Command (11/14/00)

D-2000-188 Contract Management for the National Defense Center for Environmental Excellence (9/14/00)

D-2000-170 Disposal of Range Residue (8/4/00)

D-2000-157 DoD Hazardous Waste Management and Removal Services in the U.S. European Command (6/28/00)

D-2000-127 Program Management of the Materials and Processes Partnership for Pollution Prevention (5/22/00)

D-2000-121 Hazardous Material Management for Major Defense Systems (5/4/00)

D-2000-092 Acquisition of the Minuteman III Propulsion Replacement Program (3/01/00)

D-2000-050 Disposal of Munitions Items at Fort Irwin (12/8/99)

D-2000-022 Hazardous Material Management for the Nimitz-Class Nuclear Aircraft Carrier Program (10/27/99)

D-2000-020 Hazardous Waste Disposal Costs for the Defense Logistics Agency (10/26/99)

D-2000-012 Hazardous Material Management for the F-15 Aircraft Program (10/15/99)

D-1999-256 Return on Investment from DoD Pollution Prevention Programs (9/17/99)

D-1999-251 Army Environmental Program in Germany (9/15/99)

D-1999-249 Implementation of Innovative Technology for DoD Environmental Cleanup Projects (9/9/99)

D-1999-242 Hazardous Material Management for the Black Hawk Helicopter Program (8/23/99)

D-1999-221 Hazardous Material Management for the T-45 Undergraduate Jet Pilot Training System (7/21/99)

D-1999-177 Hazardous Material Management for the C/KC-135 Stratotanker Aircraft (6/4/99)

D-1999-160 Hazardous Material Management on the Grizzly Program (5/17/99)

D-1999-020 Program Management Practice for the Installation Restoration Program at the Massachusetts Military Reservation (10/23/98)

D-1999 008 Summary Report on DoD Management of Underground Storage Tanks (10/8/98)

Mr. LIEBERMAN. It's a tough area. Cost containment historically has been a real challenge. Motivating the services to fully identify their problems has always been a problem, too.

Mr. HORN. But it just seems to me the Congress gave them the money and they ought to be administering it so the contamination can be moved at least into a brownfield situation and the community that is devastated by thousands of people being put out of work can't get anywhere and can't bring in new industry or anything else because the Department of Defense, the Navy is one of the worst snails I know, too. So when you stay around here you begin to wonder, my heavens.

Mr. LIEBERMAN. I agree with you. Congress has been generous in funding cleanup efforts. And there is a lot being done—there is the usual mix of positive and not so positive information, but I'd be happy to provide all that stuff to you.

Mr. HORN. Appreciate it. We'll have some staff go through it.

Mr. WARREN. Mr. Chairman, we've also done a number of studies in relation to the environmental cleanup and we'd be happy to provide those as well.

Mr. HORN. Great. I almost thought we had another speechwriter there with Mr. Lieberman and you sitting next to each other. So I was waiting for a speech. Mr. Warren, if you have anything else to put on the deck, let us know.

Mr. WARREN. No.

Mr. HORN. OK. Anything else you'd like to say, Mr. Lanzillotta?

Mr. LANZILLOTTA. No, sir.

Mr. HORN. Thank you for coming. So we will maybe send you all a few questions and we'll put your responses in the record here. Thank you very much.

[Whereupon, at 11:15 a.m., the subcommittee was adjourned.]

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