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DEPARTMENT OF  
DEFENSE

Financial Audits Highlight  
Continuing Challenges to  
Correct Serious Financial  
Management Problems

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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to participate in this important hearing to discuss the status of financial management at the Department of Defense (DOD). This discussion is timely in light of our recent report on the first-ever consolidated financial statements of the U.S. government subjected to audit.<sup>1</sup> The Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, also requires annual audited financial statements for DOD, along with other major individual departments and agencies across the executive branch. The goals of these acts are to promote greater accountability in managing government finances by improving financial systems, strengthening financial personnel qualifications, and generating more reliable, timely information on the costs and financial performance of government operations.

Material financial management deficiencies identified at DOD, taken together, represent the single largest obstacle that must be effectively addressed to achieve an unqualified opinion on the U.S. government's consolidated financial statements. DOD's vast operations encompass a reported over \$1 trillion in assets, nearly \$1 trillion in liabilities, 3 million military and civilian personnel, and outlays of \$262 billion in fiscal year 1997, or about 48 percent of total discretionary spending for the entire government. Consequently, DOD's operations have a tremendous impact on the government's consolidated reporting.

No major part of DOD has been able to pass the test of an independent audit; auditors consistently have issued disclaimers of opinion because of pervasive weaknesses in DOD's financial management operations. Such problems led us in 1995 to put DOD financial management on our list of high-risk areas vulnerable to waste, fraud, abuse, and mismanagement.<sup>2</sup>

The audits of DOD's and individual military services' financial statements for fiscal year 1997 performed by the DOD Inspector General (IG) and the service audit agencies, as well as our audit of the U.S. government's financial statements, have provided further clarification of the scope and magnitude of the Department's problems, and recommendations to correct them. These problems range from an inability to properly account for

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<sup>1</sup>Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998).

<sup>2</sup>High-Risk Series: An Overview (GAO/HR-95-1, February 1995) and High-Risk Series: Defense Financial Management (GAO/HR-97-3, February 1997).

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billions of dollars in assets, to not properly estimating the full extent of the government's liabilities, to not being able to accurately report disbursements and account for basic transactions. Collectively, these problems leave DOD highly vulnerable to the loss of assets and inefficient operations.

Expenditures on wasteful or inefficient operations divert scarce resources from defense priorities such as weapon systems modernization and readiness. Financial management weaknesses also greatly impede DOD's ability to have reliable and timely information needed to make sound resource decisions. Moreover, such weaknesses prevent DOD from routinely generating the type of management information needed to effectively and efficiently manage its day-to-day operations.

DOD recognizes these problems and has many efforts underway or planned to address them. However, the Department is struggling to meet the many challenges brought about by decades of neglect and an inability to fully institute sound financial management practices. Achieving the financial management goals established by the CFO Act, particularly in light of the serious and widespread nature of DOD's long-standing financial management problems, will only be possible with the sustained, demonstrated commitment of the Department's top leaders.

I will focus my remarks today on the serious material weaknesses now confronting the Department, the resulting impact on DOD's ability to effectively carry out its programs and operations, and the efforts underway to address these deficiencies. These material deficiencies include DOD's inability to

- properly account for and report billions of dollars of property, equipment, inventory, and supplies;
- estimate and report material amounts of environmental and disposal liabilities and related costs;
- determine the liability associated with the future cost of post-retirement health benefits for military employees;
- accurately report the net costs of its operations;
- properly account for billions of dollars of basic transactions, especially those between DOD component organizations and between DOD and other federal government entities; and
- ensure that all disbursements are properly recorded and reconciled.

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I will also discuss two key areas that affect the ultimate resolution of DOD's long-standing financial management deficiencies: financial management personnel training and financial systems improvement. Finally, my statement touches upon two serious governmentwide problems that are critical areas at DOD—preparations to handle the Year 2000 problem and actions needed to address computer security threats.

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## Deficiencies Related to Property, Plant and Equipment and Inventories

As discussed in our recent report on the fiscal year 1997 consolidated financial statements, the federal government—one of the world's largest holders of physical assets—does not have accurate information about the amount of assets held to support its domestic and global operations. Hundreds of billions of dollars of the more than \$1.2 trillion of these reported assets are not adequately supported by financial and/or logistical records.

With an estimated \$1 trillion in physical assets, DOD is by far the largest holder of physical assets in the federal government. DOD relies primarily on various logistical systems both to maintain accountability and visibility over its assets to meet its military objectives and readiness goals, as well as to report information on these assets in its financial statements. As part of the fiscal year 1997 financial statement audit work, auditors tested the reliability of the information in these systems. As discussed in the following sections, serious material weaknesses were found in DOD systems and processes relied on to maintain accountability and to control physical assets under its purview, including military equipment; general property, plant and equipment (PP&E); and inventories. In addition, included in these physical assets is a reported \$90 billion of government material in the hands of contractors. Accurately accounting for and controlling these contractor-held assets has been a long-standing issue in DOD. The DOD IG has issued numerous reports on this problem and is actively working with the agency to develop controls and processes to improve the accuracy of this information.

Overall, these problems impair DOD's ability to (1) know the location and condition of all its assets, including those used for deployment, (2) safeguard assets from physical deterioration, theft, or loss, (3) prevent the purchase of assets already on hand, and (4) determine the full costs of the programs that use these assets. DOD's deficiencies in these areas will also have an adverse affect on its ability to measure progress against the indicators set out in its recent Performance Plan, covering fiscal year 1999,

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prepared in response to the requirements of the Government Performance and Results Act. For example, in its plan, DOD sets out indicators of (1) achieving a 90 percent visibility rate for materiel and (2) reducing secondary inventories<sup>3</sup> from \$70 billion to \$48 billion. Weaknesses identified in DOD's logistical systems, as well as its inability to accurately determine costs, may hamper its ability to reliably determine its performance against either of these and other indicators.

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## Military Equipment Accountability and Visibility

DOD's investment in military weapons systems represents an estimated \$635 billion of the federal government's total property, plant, and equipment reported at about \$1 trillion. Accountability over these critical assets entails knowing, for each asset category, how many exist, where they are located, and their value. Overall, the auditors found that DOD's logistical systems could not be relied upon to provide this basic information. DOD relies on these systems to support not only the services' financial reports, but also to provide data on the number and location of military equipment and support operational requirements as well.

As a result, senior DOD officials did not have accurate information to use in making operational decisions or for financial reporting. To further test the accuracy of this critical logistical information, GAO, along with auditors from the offices of the DOD Inspector General and the military service audit agencies jointly conducted tests of logistical systems supporting about 80 percent of DOD's reported military equipment, by attempting to trace selected military equipment items recorded in those systems to the assets in the field. Because of the sensitive nature of the equipment selected from the systems for these existence tests, the tests were designed to either "pass" or "fail." For a number of critical systems being tested, it was agreed with the military leaders who use those systems, that a "pass" would result only where all assets selected from the system were found. For other systems, which generally carry information on less critical assets, it was agreed that up to two errors could be identified with the system still receiving a passing grade. The results of auditors' reviews and tests of the reliability of information on the numbers and locations of military equipment and each of the military service's key logistical systems are described below.

## Navy

The Navy does not have a central system that supports both financial reporting and worldwide visibility over various categories of military equipment. Instead, it relies on various systems and publications to

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<sup>3</sup>Secondary inventories are repairable and consumable items in storage at depots and installations.

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provide this information. As part of the joint tests, described previously, of DOD's reported military equipment, these systems and publications were tested to determine if reported assets actually existed.

Auditors tested recorded information for 11 categories of Navy military equipment. The Navy's systems failed for three of the 11 categories of tested military equipment—active boats, inactive service craft, and uninstalled engines. This means that the systems used to provide visibility over these mission critical items were not reliable.

- Active boats. The Combatant Craft and Boat Support System (CBSS), is used to provide senior Navy military officials visibility over the number and location of the Navy's "boats." These boats range in value up to \$8 million and include landing craft and other boats used to assist in carrying out activities such as amphibious operations, aircraft rescues, drone recoveries, and mine countermeasures. The tests for these mission critical assets—for which a "pass" allowed zero errors—found that 2 of the 45 boats selected for examination were included in CBSS as available for use, even though they had been disposed of or sold.
- Uninstalled engines. The Navy uses information from its logistical system for engines—Aircraft Engine Management System—to track all Navy aircraft engines, both installed and uninstalled. In testing this system—for which a "pass" allowed up to two errors—auditors were unable to verify the existence of 10 of the 105 sampled uninstalled engines. These 10 engines were valued at up to \$4 million each.
- Service craft. Service craft are waterborne utilitarian craft not classified as ships or boats, which provide services to the fleet in harbors, ports, and at sea. The Navy uses the Naval Vessel Register—an electronic publication updated weekly that includes custodian, fleet assignment, and condition information on the Navy's ships and service craft. This publication is relied on to maintain visibility of these assets. Auditors' tests—for which a "pass" allowed up to two errors—revealed that 6 of the 79 inactive service craft tested could not be located. Fifteen other service craft were sold or otherwise disposed of prior to the audit testing, but remained in the Naval Vessel Register coded as "Inactive." An "Inactive" coding indicates that an item was taken out of active service but was retained for possible use in meeting rapid mobilization requirements. An asset may also be placed in this category pending disposal. Table 1 shows the service craft that were no longer in the Navy's possession.

**Table 1: Service Craft Erroneously Included in the Naval Vessel Register**

Type of Service Craft	Reported Value (in thousands)	Number Sold or Disposed
Harbor Tugs	\$583 - \$873	3
Barges and Lighters <sup>a</sup>	\$20 - \$414	16
Ferry Boat or Launch	\$843	1
Floating Crane	\$468	1
<b>Total</b>		<b>21</b>

<sup>a</sup>Lighters are barges which are used in port to transport personnel, goods, etc., from ship to ship or ship to shore.

In addition, auditors’ tests of systems supporting inactive ships and boats, which were permitted up to two errors before the systems failed due to the less critical nature of these military equipment categories, showed that these systems included one inactive cargo ship and two inactive boats which had been disposed of or sold. The Naval Audit Service is in the process of developing a report containing recommendations for actions to address these critical issues.

**Army**

The Army relies on a central logistics system, the Continuing Balance System-Expanded (CBSX), to maintain worldwide visibility for all military equipment, including the Army’s most critical war fighting equipment (national defense assets including tanks, cannons, armored personnel carriers, and aircraft). The system is intended to provide accurate, timely, and auditable equipment status information necessary for direct troop support. The central system should mirror the official accountable records of equipment balances, such as property book records maintained by various Army activities, including Army divisions that may be deployed, depots that repair or upgrade equipment, and storage sites.

The Army calculates a compatibility rate to measure the extent to which the central system and the property book records agree—with a 98 percent compatibility rate as a goal.<sup>4</sup> As of July 1997, the Army reported an Army-wide compatibility rate of about 92 percent. However, in January 1998, we reported that the 92 percent rate is overstated because Army does not include all the adjustments that are made to records.<sup>5</sup> If these adjustments were included in the calculation, the Army-wide rate would fall to about 87 percent.

<sup>4</sup>Army calculates the compatibility rate as a ratio of the total number of adjusted equipment items to the total number of equipment items on hand, expressed as a percentage.

<sup>5</sup>Army Logistics Systems: Opportunities to Improve the Accuracy of the Army’s Major Equipment Item System (GAO/AIMD-98-17, January 23, 1998).



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In addition, we reported that the compatibility rate calculation does not provide a complete indicator of the central system's accuracy because it does not include errors associated with equipment that is in-transit between locations. These in-transit errors are significant—when they occur, the Army loses visibility over this equipment. In June 1996, the Army Audit Agency reported that as of July 31, 1995, 69 percent of the 1,135 open in-transit records in the central system it analyzed were invalid. The auditors identified a number of reasons for the invalid in-transit records, including system interface problems, use of duplicate unit identification codes, and shipments that were redirected to another destination after the shipment was initiated.<sup>6</sup>

We recently analyzed a statistically projectable sample of adjustments made to data in the central system to bring it into agreement with data in the Army's primary property book system. Our analysis showed that over 40 percent of the adjustments were needed because of transactions that had been recorded in unit level property books, but not received by the central system. Until these adjustments were made, assets including Howitzer cannons, M-16 rifles, and cargo trucks were not reflected in the central system. For example, one of the adjustments was for a Howitzer M-119 cannon, used for firing shells at a high angle of elevation to reach a target behind cover or in a trench and valued at approximately \$423,000, that had been recorded in a deployed unit's property book, but the transaction was not received by the central logistical system.

These problems are long-standing. In a 1993 study,<sup>7</sup> we found that the Army did not maintain reliable information on the types, quantities, and locations of its equipment. For example, we found that one unit's equipment records indicated having 220 more tanks than were being reported in the central system. In another instance, a unit reported 18 advanced attack helicopters which were not recorded in the central system. Such discrepancies not only result in financial reporting misstatements, but, as DOD acknowledged in its "Lessons Learned" report following Desert Storm, inaccurate or unreliable central system data can impair equipment distribution decisions. As a result, some units received equipment in excess of their authorized levels, while other units were not provided critically needed equipment. Our recent report identified specific reasons for discrepancies between central system and unit accountability records and made nearly 20 detailed recommendations, including

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<sup>6</sup>Financial Reporting of Equipment In Transit (U.S. Army Audit Agency, AA 96-156, June 17, 1996).

<sup>7</sup>Financial Management: Army Lacks Accountability and Control Over Equipment (GAO/AIMD-93-31, September 30, 1993).

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suggestions to (1) ensure that the central system receives applicable property book transactions, (2) correct software problems, (3) improve the transaction audit trail, and (4) enhance the training of property book officers.<sup>8</sup>

Because of the known problems with the Army's central system, the auditors focused the existence tests, described previously, of the Army's recorded assets on its unit-level property books which are used to provide information to the central system, and on other logistical systems containing asset information. The tests were designed to validate the existence of assets for the five categories of military equipment that comprised 70 percent of the reported value of Army mission assets. These categories are aircraft, combat tracked vehicles, communication equipment, missiles, and missile support equipment. The data in the Army's property books passed the auditors' tests for existence for each of the five asset categories. However, the auditors found two errors in the missile support category, one of which was a critical military equipment item.

Specifically, one missile launcher for an AVENGER weapon system could not be located. The AVENGER weapon system is a lightweight, highly mobile surface-to-air missile/gun system which can be mounted on a High Mobility MultiPurpose Wheeled Vehicle (HMMWV). Each AVENGER launch system costs approximately \$1 million. Army officials' explanation for problems in locating the missile launcher was that the serial number listed in the Army's records for the AVENGER missile launcher was in fact the serial number of the HMMWV and that the launcher had been removed from the HMMWV. As of April 9, 1998, this launcher had not been located. The Army Audit Agency's draft report on "Accountability for Army Mission Equipment" recommends that the Deputy Chief of Staff for Logistics establish specific criteria and procedures for recording serial numbers in unit property books for high-dollar value components of equipment items.

## Air Force

Our recent work identified problems with the Air Force's Reliability and Maintainability Information System (REMIS), which is intended to provide worldwide visibility over its equipment, such as aircraft and missiles, and timely maintenance and logistical information. This central logistical system is used to support Air Force field and operational commanders. Over 1,700 users have access to various modules of the central system to support a variety of activities including strategic planning, asset

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<sup>8</sup>Army Logistics Systems: Opportunities to Improve the Accuracy of the Army's Major Equipment Item System (GAO/AIMD-98-17, January 23, 1998).

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accountability, and budgeting. As with the Army's central logistical system, the accuracy of the data in the Air Force system is important not only for financial reporting, but also for effective asset control and program management. The Air Force central system includes three databases: (1) an inventory table, which identifies equipment by serial number and type, (2) an assignment table, which shows the assigned command and mission for aircraft and missiles by serial number, and (3) a possession table, which identifies the physical location of aircraft and missiles by serial number. These databases generally should be consistent. However, we reported<sup>9</sup> in August 1997 that our analyses of these three databases identified a number of inconsistencies in the number of aircraft and missiles reported. For example, our findings included the following.

- Over 200 ground launched cruise missiles were identified in the assignment table that were not included in either of the other central system databases. According to the system program office, these missiles were destroyed years ago as part of a treaty with the Soviet Union.
- Twelve aircraft and missile records were erroneously included in the inventory table (they did not appear in the assignment or possession table). It was determined that these records did not represent actual equipment and therefore should have not been in the central system inventory table.
- Twenty-five aircraft and eight air-launched cruise missiles were included in the central system inventory and assignment tables, but were not in the possession table. These assets were not reflected in the possession table because the table had not been updated to reflect asset transfers from one location to another.
- Duplicate records for 10 helicopters were included in the central system inventory database. This error occurred as the result of improper data entry when making modifications to type/model/series information.

We recommended short-term actions the Air Force could take to improve the accuracy of aircraft and missile data in its central logistical system. Such actions included making regular comparisons and analyses of the central system databases and researching and correcting any inconsistencies, such as the mismatches we identified.

In addition, the systems the Air Force relied on to account for and control military equipment "passed" the existence tests described previously. However, the auditors identified errors, which, although within the

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<sup>9</sup>Financial Management: Accuracy of Air Force and Missile Data Could Be Improved (GAO/AIMD-97-141R, August 15, 1997).

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acceptable limits of the auditors' tests for a passing mark on the equipment reported in the system, may raise concerns over the reliability of location information on critical items in the Air Force's arsenal of military equipment. Specifically, as part of the auditors' tests, they determined that (1) two engines included in the logistical system records as uninstalled engines were actually installed in aircraft several years ago, and (2) an older model C-130 cargo plane remained in the logistical records even though the aircraft had been destroyed a few years ago at a contractor facility during corrosion testing. In addition, while not specifically part of the auditors' financial audit testing, they noted that the Air Force's logistical records on the location of 46 engines, valued at \$91,000 each, were incorrect. Air Force officials informed the auditors that erroneous information was included in the logistical systems primarily because the contractors had not updated the records when these assets were transferred from the contractor's facility. The auditors offered specific suggestions to correct these deficiencies noted as part of their audit tests.

#### Improvement Efforts

Both the Army and Air Force have indicated that they either have taken, or are taking, actions to address auditor concerns and improve these critical systems. To improve its central logistical system, the Army established an Improvement Team to develop initiatives related to data accuracy in its central logistical system and hired a contractor to carry out those initiatives. Defense Finance and Accounting Service and Air Force officials indicated that they had completed actions to address our recommendations on specific actions to improve the Air Force system. We plan to follow up the effectiveness of these actions as part of our fiscal year 1998 financial audit work at DOD. The Navy has not yet indicated what actions it will take.

#### Equipment Valuation

Auditors have had long-standing concerns that the reported value of DOD's military weapons systems was inaccurate. Recent audit results demonstrate that DOD continues to experience problems in this area. For example, Army auditors recently reported that limited testing of the recorded value of selected military equipment items revealed an understatement of more than \$10 billion as a result of the Army not updating unit price information to reflect standard price. The Army adjusted its financial statements for that amount, but Army auditors reported that the account balance was still misstated by an unknown amount for the equipment items that were not tested.

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The Department's most recent annual report to the President and the Congress describes the significance of DOD's inability to develop reliable cost information. Specifically, the report cited the lack of a cost accounting system as the single, largest impediment to controlling and managing weapon system life-cycle costs, which include acquisition costs, as part of DOD's acquisition reform initiative to acquire products "that work better and cost less." In this regard, DOD identified as a specific goal, establishing an implementation plan for a cost accounting system that provides visibility over weapon system life-cycle costs. Without accurate information on the acquisition costs of weapon systems, neither DOD officials nor the Congress can make fully-informed decisions about which weapons or how many to buy. Moreover, DOD management needs accurate cost information to monitor costs as weapon systems are being built, especially for those weapons for which Congress imposes cost limits.

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## Unreliable Amounts Reported for General Property, Plant and Equipment

In addition to military equipment, DOD is responsible for almost one-half of the government's general property, plant and equipment (PP&E).<sup>10</sup> Long-standing issues affecting the reliability of reported general property amounts include DOD's inability to ensure that all its assets are properly reported and valued. DOD auditors restated again in recent audit reports that the billions of dollars reported for real property (land, buildings, facilities, capital leases, and improvements to those assets) and non-military equipment, such as trucks, telecommunications systems, and computers, were unreliable due to valuation errors, omissions of assets, system deficiencies, or other recording errors, such as duplicate reporting.

With regard to valuation, auditors were unable to verify the reported amount of DOD's property. In general, documentation supporting these values no longer exists or cannot be located. In addition, obviously erroneous valuation data are not being corrected. For example

- At one location tested, Navy auditors identified 49 buildings valued at a total of \$25 million that were recorded at a zero or one dollar value in the system used to obtain the plant property values for the Navy's fiscal year 1997 financial statements.

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<sup>10</sup>Statement of Federal Financial Accounting Standards No. 6 states that general PP&E is any property, plant, and equipment used in providing goods and services. It typically has one or more of the following characteristics: (1) it could be used for alternative purposes (e.g., by other Federal programs, state, or local governments, or non-governmental entities) but is used to produce goods or services, or to support the mission of the entity, (2) it is used in business-type activities, or (3) it is used by entities in activities whose costs can be compared to those of other entities performing similar activities (e.g., Federal hospital services in comparison to other hospitals).

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- The Air Force's fiscal year 1997 financial statements were understated by \$189 million because of pricing errors entered into the system for fire trucks. The fire truck amounts were based on a unit price of \$1.03 instead of the actual cost of over \$470,000.

In certain cases, some DOD general property is being omitted from reports. For example, DOD auditors reported problems at each military service related to DOD's inability to properly identify and report its capital leases. Air Force and Navy auditors determined that capital leases with an estimated total value at \$493 million were omitted from Air Force and Navy fiscal year 1997 financial statements.

Finally, DOD auditors have identified the lack of integration of financial accounting and property accounting systems as a major factor contributing to unreliable general property reporting. Accordingly, the DOD Comptroller designated the Defense Property and Accountability System (DPAS) as the property accounting system for all DOD real and personal property in order to bring DOD assets under proper accountability and financial control. We recently reported<sup>11</sup> that the DOD-wide system, as functionally designed, can provide financial control and generate information to account for most general property. However, we also reported that if not properly implemented, as was the situation at the Defense agency we reviewed, the DOD-wide system would not ensure financial control and accurate reporting of general property. Furthermore, while the DOD Comptroller has stated that this system must be implemented across DOD by the year 2000, no specific plans to accomplish this goal have been developed. The responsibility for implementing this system was recently turned over to the Defense Logistics Agency. Our report made 10 detailed recommendations to ensure that financial control and accountability over general property is attained. These include developing an implementation plan with milestones for DPAS, revising the handbook accompanying the system, and modifying the software to update it for new accounting standards.

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## Capitalization Threshold

DOD's ability to accurately report its property, plant, and equipment values has been further hampered by the 20-fold increase in its capitalization threshold from \$5,000 in 1991 to \$100,000 in 1996. Prior to fiscal year 1998, DOD policy required DOD components to capitalize an asset when its acquisition cost or similar cost exceeded the capitalization threshold in

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<sup>11</sup>Financial Management: DOD's Approach to Financial Control Over Property Needs Structure (GAO/AIMD-97-150, September 30, 1997).

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effect at the time of acquisition. Beginning in fiscal year 1998, however, DOD components—other than working capital fund activities—are required to apply a single \$100,000 capitalization threshold to assets, irrespective of the threshold that existed at the time of purchase. Under this policy, all general PP&E assets, previously capitalized by non-working capital fund activities at thresholds less than \$100,000, will be expensed in fiscal year 1998. Recognizing the effect this policy would have on operations, working capital fund activities are required to apply the capitalization threshold only to newly acquired assets, beginning in fiscal year 1998, and to retain, on their financial records, existing capitalized assets even though the assets may have been capitalized at a level of less than \$100,000.

Prior audit reports have disclosed that higher capitalization thresholds have not been uniformly applied throughout DOD, resulting in inconsistencies in asset reporting and the omission of billions of dollars in assets from DOD financial reports. As a result of the higher capitalization threshold, billions of dollars of assets have been expensed—effectively removing them from accounting control. For example, Navy auditors estimate that if the \$100,000 capitalization threshold were applied to the Navy's March 1996 nonmilitary equipment balance of \$6 billion, over \$1 billion would be eliminated. In a letter to DOD in March 1997, we estimated that at least \$5 billion of the Army's equipment would have been excluded from the Army's fiscal year 1996 financial statements if the \$100,000 threshold was retroactively applied. Eliminating these items from financial control and the accountability imposed by annual audits is particularly detrimental because, as discussed earlier, financial audits have repeatedly found that DOD's detailed property records are not accurate.

Further, use of this high capitalization threshold adversely affects the measurement of operating costs. Billions of dollars of assets are expensed in their year of acquisition, as opposed to the cost of those assets being allocated over the life of the asset. For example, as a result of implementation of high capitalization thresholds, thousands of tractors costing at least \$70,000 each and numerous types of industrial equipment have been written off in the year of acquisition. In addition, expensing these costs makes it harder for DOD to compare its cost to the private sector, which is required to capitalize such items. For example, this impairs the ability of DOD and oversight officials to make informed decisions on issues where comparative costs are a significant factor, such as in deciding whether to outsource specific functions.

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We are analyzing the effect of DOD's capitalization policy on its operational and program costs and asset accountability and will be continuing to discuss our views with DOD managers.

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## Inventory Cannot Be Verified

DOD inventory<sup>12</sup> includes ammunition (such as machine gun cartridges, rocket motors, and grenades), consumables (such as clothing, bolts, and medical supplies), stockpile materials (such as industrial diamonds, rubber, and tungsten), and repairable items (such as navigational computers, landing gear, and hydraulic pumps). DOD's inability to effectively account for and control its reported \$170 billion investment in inventories has been an ongoing area of major concern. We are continuing to monitor DOD inventory management as one of the areas that we consider as high risk because of its vulnerability to waste, fraud, and abuse. One area of inventory management that has been a long-standing concern is excess inventories. In February 1997, we reported our estimate that about half of DOD's \$70 billion in secondary item inventories<sup>13</sup> at the end of fiscal year 1995 was excess to current operating requirements and war reserves.<sup>14</sup>

Auditors continue to find that DOD's inventory management and control systems and practices are plagued with serious problems, including

- on-hand quantities that do not agree with the records,
- an inability to reliably determine inventory values,
- deficiencies in information on the condition of inventories,
- a significant amount of inventory excluded from overall logistics management visibility as well as financial reporting, and
- an inability to effectively account for and control in-transit inventories.

## On-Hand Quantities Do Not Agree With Records

Auditors have issued a number of reports over the past several years detailing extensive discrepancies between the results of physical counts of inventories actually on hand and quantity information recorded in inventory records. For example, in their fiscal year 1997 audit opinion on the Army's Working Capital Fund, Army auditors cited unacceptable error

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<sup>12</sup>Statement of Federal Financial Accounting Standards No. 3 defines several categories of inventory. DOD primarily has inventory held for sale, operating materials and supplies, and stockpile materials. For purposes of this testimony, we refer to all categories as inventory.

<sup>13</sup>Secondary inventories are repairable and consumable items in storage at depots and installations.

<sup>14</sup>High-Risk Series: Defense Inventory Management (GAO/HR-97-5, February 1997).



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rates in prior years' testing of inventory records.<sup>15</sup> The DOD IG reported an overall 24 percent error rate at DOD's primary storage locations as a result of physical counts it performed in fiscal year 1996.<sup>16</sup> The auditors' examination of inventories in the fiscal year 1997 financial statements found this condition continued. For example:

- Navy auditors performed physical counts at 13 major Navy storage locations. Their preliminary results indicate that the quantities actually on hand differed from inventory records 23 percent of the time. Out of 652 stock numbers tested, 150 had count quantities that differed from the inventory record quantities.
- Air Force auditors found that Air Force records showed \$4.5 billion of Air Force ammunition was stored at Army locations as of the end of fiscal year 1997, but Army records showed only \$2.5 billion.<sup>17</sup> Of the \$2 billion difference, the auditors could only resolve \$864 million, which was the result of Air Force records showing that it had 14.5 million smoke rockets (used to mark targets) at an Army storage location, while only 1,450 were actually on hand at that location. The item manager was not aware of this difference until the auditors pointed it out.

As a result of these deficiencies in recorded inventory quantities, DOD managers do not have reliable information to make purchase decisions or to fully recognize and eliminate excess inventories and related storage costs. For example, in February 1997, we reported that DOD had ordered \$11.3 million in additional items, such as circuit card assemblies, computers, and hydraulic pump valves, that already were in excess supply.<sup>18</sup> In June 1996, we reported that about \$31 billion of DOD's reported \$80 billion of ammunition was excess.<sup>19</sup> In January 1997, we reported that DOD could save about \$382 million annually in holding costs by eliminating an estimated \$2.7 billion in inventories not needed to meet current operating and war reserve requirements.<sup>20</sup>

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<sup>15</sup>Army Working Capital Fund Principal Financial Statements for Fiscal Year 1997 (AAA Report No. AA 98-111, February 13, 1998).

<sup>16</sup>Inventory Record Accuracy and Management Controls of the Defense Logistics Agency Distribution Depots (DOD IG Report No. 98-019, November 10, 1997).

<sup>17</sup>Opinion on Fiscal Year 1997 Air Force Consolidated Financial Statements (AFAA Report No. 97053009, February 27, 1998).

<sup>18</sup>Defense Logistics: Much of the Inventory Exceeds Current Needs (GAO/NSIAD-97-71, February 28, 1997).

<sup>19</sup>Defense Ammunition: Significant Problems Left Unattended Will Get Worse (GAO/NSIAD-96-129, June 21, 1996).

<sup>20</sup>Defense Inventory: Spare and Repair Parts Inventory Costs Can Be Reduced (GAO/NSIAD-97-47, January 17, 1997).

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## Inventory Values Questionable

Federal accounting standards require inventories to be valued based on historical cost or a method that will approximate historical cost. DOD does not have historical cost data on inventories. Accordingly, DOD developed an agencywide model in 1994 to approximate historical cost. The model requires adjustments to recorded inventory values to arrive at the estimated historical cost. These adjustments are a key factor in determining the working capital funds' cost of operations.

Auditors have been unable to evaluate the reasonableness of reported inventory values due to errors and wide swings in the dollar value of adjustments made to value inventory at historical cost using this model. For example, the application of the model in Navy for its fiscal year 1996 financial statement reporting resulted in about an \$8 billion adjustment to Navy's Working Capital Fund inventory and in a net loss of \$3.4 billion. However, during 1997, DFAS later identified a \$3.9 billion error in how the model was applied to the fiscal year 1996 inventory balances, which caused that year's ending inventory balance to be understated by the same amount.

Further, the model has undergone frequent changes that have not been well documented and, therefore, the impact of the changes has been difficult to follow. Nevertheless, the changes could have been one reason that the Navy's reported inventory balances fluctuated significantly between fiscal years 1995 and 1997. For example, the Navy's Working Capital Fund reported inventory balances were about \$13 billion in fiscal year 1995, \$10 billion in fiscal year 1996, and \$13 billion again in fiscal year 1997.

As a result, the model DOD is using to value inventories has yet to demonstrate that it can reliably approximate historical cost as required by standards. DOD's September 1997 working capital funds improvement plan recognized the need to properly value inventories at historical cost. However, until DOD can develop and validate such a model or capture its inventory costs, DOD will continue to have little assurance that it can develop and report accurate net operating result information—a key factor in setting the prices DOD's working capital fund operations charge their customers. Auditors are working with DOD to determine if the model can be modified to provide more accurate estimates as an interim measure until DOD obtains actual inventory costs.

## Assets With Unknown Condition

DOD's financial statements are required to provide information on the condition of inventories. For example, items held for repair should be

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segregated and reported at values reduced by the costs of bringing those assets up to serviceable condition. However, Army auditors reported that the Army's fiscal year 1997 Working Capital Fund financial statements did not properly report inventory held for repair.<sup>21</sup> In addition, we reported in December 1997 that the Air Force had over 400,000 secondary items valued at \$2.4 billion for which it had not determined the usability or condition.<sup>22</sup> For about 64 percent of the almost 2,000 items we reviewed, we found that Air Force records were not updated to reflect the item condition for over 1 year and in some instances had not been updated for over 6 years. Lacking reliable information on inventory condition, DOD may not have an accurate picture of the amount needed to bring these items to a serviceable state, which could affect readiness or may result in DOD incurring unnecessary storage costs for those items for which it is not economically feasible to repair and should be disposed of.

## Inventories Not Reported

As disclosed in our recent report on the results of our audit of the U.S. government's consolidated financial statements, an estimated \$9 billion of known military operating materials and supplies were not reported, including inventories on Army installations, at Navy facilities, and on Navy ships. Further, as part of their fiscal year 1997 audit, Army auditors found that Army records were understated by \$248.9 million because munitions balances in Kuwait and those held by a contractor were not reported.<sup>23</sup> In the case of the contractor, the auditors confirmed that the contractor's records showed 3,873 more rocket pods (a rocket pod contains 12 surface-to-surface rockets and is part of a mobile rocket launching system) than the Army's records. This variance, representing about 14 percent of the total 27,766 rocket pods the Army has in its inventory, occurred because the Army relied on manual reporting procedures from the contractor. This is not a new problem. For example, in its fiscal year 1996 audit, the Naval Audit Service found that the Navy's reported ammunition balances were understated by \$20.4 billion because the source Navy used to prepare its financial statements did not include all ammunition owned by the Navy.<sup>24</sup>

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<sup>21</sup>Army Working Capital Fund Principal Financial Statements for Fiscal Year 1997 (AAA Report No. 98-111, February 13, 1998).

<sup>22</sup>Defense Inventory: Inadequate Controls Over Air Force Suspended Stocks (GAO/NSIAD-98-29, December 22, 1997).

<sup>23</sup>Army's Principal Financial Statements for Fiscal Year 1997 and 1996—Financial Reporting of Wholesale Munitions (AAA Report No. 98-98, February 5, 1998).

<sup>24</sup>Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Internal Controls and Compliance With Laws and Regulations (NAS Report No. 029-97, April 5, 1997).

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The adverse effect of not having information on these inventories was highlighted in our March 1998 report on our analysis of Navy financial data deficiencies.<sup>25</sup> We discussed a number of areas in which logistics systems' financial deficiencies not only adversely affected the reliability and usefulness of the Navy's financial reporting but also had significant programmatic or budgetary implications. For example, to determine Navy-wide inventory requirements, responsible managers must have accurate, reliable information on the quantities of inventories on ships, including any quantities in excess of needs. However, we reported that information on almost \$8 billion of inventories on-board ships were omitted from the data used from financial statement reporting and as the starting point for the development of budget requests for additional inventories.

As a result, there was a substantially increased risk that Navy may have requested funds to obtain additional unnecessary inventories because responsible managers did not receive information on excess inventories that were already on hand in other locations. For example, in our August 1996 report, we identified unnecessary Navy spending of at least \$27 million in fiscal year 1995 and forecasted spending which could result in the Navy incurring another approximately \$38 million in the future for items already available at other locations.<sup>26</sup>

### Poor Accounting for In-Transit Inventories

In their audits of fiscal year 1997 working capital fund financial statements, auditors were not able to confirm the in-transit inventory balances, which are included in the reported overall inventory balance on hand. For example, Army auditors found that a reported \$598 million of inventory in-transit from vendors was misstated by an unknown but material amount due to problems with processing receipt notifications.<sup>27</sup> Air Force auditors could not validate \$11 billion of inventories at contractor repair facilities and in transit between contractors and Air Force installations because the systems did not maintain supporting records.<sup>28</sup>

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<sup>25</sup>CFO Act Financial Audits: Programmatic and Budgetary Implications of Navy Financial Data Deficiencies (GAO/AIMD-98-56, March 16, 1998).

<sup>26</sup>Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings (GAO/AIMD-96-94, August 16, 1996).

<sup>27</sup>Army Working Capital Fund Principal Financial Statements for Fiscal Year 1997 (AAA Report No. 98-111, February 13, 1998).

<sup>28</sup>Opinion on Fiscal Year 1997 Air Force Working Capital Fund Financial Statements (AFAA Report No. 97068043, February 27, 1998).

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We also recently reported on problems with verifying in-transit inventory balances. In February 1998, we reported that the \$5.2 billion of in-transit secondary item inventory shown in DOD's fiscal year 1996 Supply System Inventory Report is questionable because (1) the Air Force did not include \$1.3 billion of in-transit repairable items, and (2) DOD did not have receipt notifications for 12.4 million shipments outstanding for an average of 145 days—approximately 1.4 billion items—out of 21 million shipments it initiated.<sup>29</sup> The logistical systems supporting this report also are the source of financial information.

Taken together, these inventory control and accountability deficiencies also serve to undermine the Department's ability to reliably meet established performance objectives. For example, performance indicators were set out in the Department's recent performance plan, including reductions in retail-level inventories, such as repairable and consumable items at bases, from \$14 billion in fiscal year 1996 to \$10 billion in fiscal year 2001, and reductions in supply inventories, such as repairable and consumable items in storage, from \$70 billion in fiscal year 1995 to \$48 billion in 2003. These performance indicators do not address the remaining balance of the reported \$170 billion of inventory, including ammunition and other operating supplies. Until DOD can reliably account for both the quantity and value of its substantial investment in inventories, its ability to assess its progress in meeting such goals will be impaired.

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## Reported Environmental/ Disposal Liability Is Significantly Understated

DOD has not yet fully implemented the federal accounting standard that requires it to recognize and report liabilities associated with environmental cleanup and/or disposal of its assets, including ammunition, national defense assets,<sup>30</sup> military training ranges, and chemical weapons. While DOD reported \$38.7 billion in estimated environmental cleanup and disposal liabilities in its fiscal year 1997 financial statements for environmental restoration of active and inactive bases, cleanup of formerly used sites, and cleanup and disposal of certain chemical weapons, it did not estimate environmental cleanup and disposal costs associated with military weapons systems or training ranges. As a result, DOD's undisclosed liability in this area is likely understated by tens of billions of dollars.

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<sup>29</sup>Department of Defense In-Transit Inventory (GAO/NSIAD-98-80R, February 27, 1998).

<sup>30</sup>Includes weapons systems such as submarines, ships, aircraft, missiles, and combat vehicles.

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One of the new accounting standards<sup>31</sup> requires recognition of a liability for any probable and measurable future outflow of resources arising from past transactions, if those costs can be reasonably estimated. These requirements apply to many DOD assets, including its weapons systems, which contain hazardous materials and waste that must be removed and disposed of when inactivated. The new federal accounting standard was issued more than 2 years ago to allow agencies ample time to develop implementing policies and procedures prior to its fiscal year 1997 implementation date. The Congress has also recognized the importance of accumulating and considering such information. The National Defense Authorization Act for Fiscal Year 1995 requires the Secretary of Defense to determine, as early in the acquisition process as feasible, the life-cycle environmental costs for major defense acquisitions programs, including the materials to be used and methods of disposal. The life-cycle cost estimates are required before proceeding with the major acquisition.

Because of the importance of this information and because of our responsibility to audit the U.S. government's consolidated financial statements beginning with fiscal year 1997, we undertook a series of reviews to assist DOD in its efforts to meet the requirements of the new federal accounting standard. We found that, while DOD has not yet estimated its disposal liability for all assets, including national defense assets, information is available to estimate these costs. We have reported the following.

- DOD regularly disposes of missiles and includes disposal costs for missiles as part of its annual budget request. Using available information, the military services were able to provide us with estimated disposal costs, ranging from \$102 to almost \$500,000 per missile for each of four missile types we selected for review.<sup>32</sup>
- Navy management information systems contain data on the costs to inactivate and dispose of nuclear submarines and ships. For example, these systems show that estimated environmental costs associated with inactivation and disposal activities related to a nuclear submarine could range, at a minimum, from \$19 million to \$61 million. Navy officials also provided a cost estimate that ranged from \$807 million to \$942 million for the inactivation and disposal of the first Nimitz-class nuclear carrier, if

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<sup>31</sup>Statement of Federal Financial Accounting Standards No. 5, Accounting for Liabilities of the Federal Government.

<sup>32</sup>Financial Management: DOD's Liability for Missile Disposal Can Be Estimated ([GAO/AIMD-98-50R](#), January 7, 1998).

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work was begun in fiscal year 1998.<sup>33</sup> Subsequently, they stated that as the Navy gains experience in defueling during the refueling cycles of Nimitz-class carriers, they expect the cost estimate for inactivating and disposing of Nimitz-class carriers could be reduced to about \$500 million for the tenth Nimitz-class carrier. Although the Navy has not provided a basis for us to assess the reasonableness of the \$500 million estimate, we acknowledge that as the Navy gains experience in the inactivation and disposal of aircraft carriers, cost efficiencies could occur. Ultimately, the estimate will need to be adjusted to reflect actual experience.

- DOD's designated aircraft storage, reclamation, and disposal facility could provide data to compute estimated costs for the demilitarization (ranging from about \$7,000 to \$105,000 for three of the aircraft we reviewed) and hazardous material removal (ranging from \$313 to \$123,000 for the five aircraft reviewed) for aircraft systems.<sup>34</sup>
- DOD can use historical cost information on ammunition disposal already compiled as a starting point for estimating its ammunition disposal liability. Using these data, along with inventory quantities provided by the Army, we estimated that the Army's ammunition disposal liability alone could range from about \$1.3 billion to \$2.1 billion.<sup>35</sup>

DOD also faces significant cleanup and disposal costs for its military training ranges. These costs, which are related to clearing the land of unexploded ordnance and other chemical wastes, are also estimable. In a July 1996 study, DOD estimated that \$19.5 billion would likely be needed to secure and/or clear inactive, closed, or transferring ranges under current legal requirements; however, DOD did not include any estimate for these costs in its fiscal year 1997 financial statements. Also, this amount should have been, but was not, included in DOD's 1996 Defense Environmental Restoration Program Annual Report to the Congress.

In response to our reports, DOD has stated that, while it generally agreed that estimates could be developed for certain assets, estimates covering all assets would take some time. It added that it has delayed reporting of most of these liabilities because of the time required to develop and implement policy and specific application procedures and reporting guidance.

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<sup>33</sup>Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Material in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997).

<sup>34</sup>Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997).

<sup>35</sup>Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997).

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As the Department begins developing needed policy and specific guidance for the military services on estimating and reporting the disposal liability for assets, our reports identify certain factors that need to be addressed. In addition, because environmental and disposal liabilities represent future outlays, DOD should also consider ways to make this information even more meaningful to decisionmakers. One way to provide a proper context for environmental liabilities would be to provide a table showing estimated outlays by budget period in a footnote to the financial statements. Such a table would show congressional and other budget decisionmakers the potential annual impact of DOD's actions on various budget periods, including those outside the annually submitted Future Years Defense Program. This information could also provide a link between budgetary and accounting information, one of the key objectives of the CFO Act.

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## Reported Liability for Post-Retirement Health Care Is Unsupported

Under the new accounting standards, DOD is required to calculate and report its estimated liability for providing health care benefits to military retirees and their beneficiaries. DOD provides these benefits through free care at Military Treatment Facilities and through the Tricare program, which is comprised of fee-for-service (CHAMPUS), preferred provider, and HMO plans.

DOD did not accumulate the data necessary to accurately estimate its military post-retirement health benefits liability. Specifically, DOD used unaudited budget information, instead of the required cost data, to calculate its \$218 billion estimated liability. In addition, DOD did not accumulate current or complete historical claims data to support its calculation. These problems significantly impair DOD's ability to determine the full cost of its current operations or the extent of its actual liabilities.

According to both DOD actuaries and independent actuaries under contract to DOD, the current cost of providing health care cost is very significant to the liability calculation—if costs are understated or overstated by a percentage point, the liability will be understated or overstated by approximately the same percentage. However, DOD did not accumulate actual cost data for its Military Treatment Facilities. Instead, DOD estimated health care spending using budget obligation data and used this information in the calculation. While budget obligations represent funds committed during a period, they are not equivalent to full cost data. For example, the costs of the treatment facilities themselves may not be fully captured nor some personnel costs such as future pension expenses.



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DOD did not obtain a significant portion of health care claims data. For outpatient claims, which comprise over one-third of the dollar value of all claims, data were available from only 15 of the 121 Military Treatment Facilities. The actuaries assumed that the 15 were representative of the entire 121, which resulted in an unquantifiable error in the liability calculation. Finally, the actuaries did not obtain the most current data available; instead, claims data from fiscal year 1994 were the most recent used in the calculations for the fiscal year 1997 liability.

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## Cost of DOD Operations Not Accurate

As stated in our report on the results of our audit of the U.S. government's consolidated financial statements, the government was unable to support significant portions of the more than \$1.6 trillion reported as the total net costs of government operations. DOD accounts for about \$250 billion of this amount. The previously discussed material deficiencies in DOD's ability to report assets and liabilities and the lack of effective reconciliations, as discussed later, all affect the department's reported net costs. Specifically, as previously discussed, the accuracy of DOD's operating costs is materially affected by DOD's inability to (1) properly value and capitalize its facilities and equipment, (2) properly value its inventory, (3) identify its environmental and disposal costs, and (4) determine its costs associated with post-retirement health care for military personnel. Further, as discussed in the following sections, DOD's inability to properly identify and eliminate interagency transactions, reconcile balances with Treasury, and record all of its disbursements are additional factors in the incomplete picture of DOD's costs.

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## DOD Cannot Identify Interagency Transactions

To make the consolidated governmentwide financial statements balance, Treasury had to record a net \$12 billion item on the Statement of Changes in Net Position, which it labeled unreconciled transactions. This out-of-balance amount was the net of more than \$100 billion of unreconciled transactions—both positive and negative amounts—which Treasury attributed largely to the government's inability to properly identify and eliminate transactions between federal government entities.

In order to portray DOD as a single entity and the federal government as a single economic unit, certain transactions that occur between entity components must be identified and eliminated. Without proper eliminations, certain assets, liabilities, revenues and expenses are double counted or otherwise misstated. However, DOD has acknowledged that it cannot reliably identify and eliminate interagency transactions, whether

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between individual DOD components or between DOD and other federal government entities.

For the consolidated governmentwide financial statements, DOD identified its side of interagency transactions for elimination without reconciling its accounts with other federal government entities. Therefore, DOD had no assurance that it had identified the correct amounts and that a corresponding revenue, expense, asset or liability had been identified by the transaction partner. Improper eliminations can result in significant errors in financial statement reports. For example, as part of the nearly \$300 billion of interagency transactions reported to Treasury, DOD identified \$59 billion of program and operating expenses for elimination but later could not justify \$42 billion as interagency transactions. As a result, Treasury had to adjust the consolidated net cost statement to correct this error. If Treasury had not made the necessary adjustment, the consolidated Statement of Changes in Net Position, which currently shows the government's costs exceeded its revenues by \$15 billion, would have indicated that the government's revenues exceeded its costs by \$27 billion for fiscal year 1997.

Because improving DOD systems will be a long-term endeavor, we are continuing to work with DOD, OMB, and Treasury to develop an acceptable interim process to resolve problems in accurately accounting for and reporting interagency transactions.

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## DOD Has Billions of Unreconciled Cash Activity

As discussed in our report on the results of our consolidated audit of the federal government, several major agencies are not effectively reconciling their transactions. DOD, with nearly half of the federal government's discretionary spending, is one of those agencies. These reconciliations—similar in concept to individuals reconciling personal checkbooks with a bank's records each month—are a key control to ensure that agencies' and Treasury's records agree on the amount of funds spent and that remain available, as well as to ensure that all transactions are recorded to capture the costs of an agency's activities.

As important as these reconciliations are to all federal agencies, these are critical for DOD. This is because authorized transactions are often charged to DOD's appropriation accounts by entities not directly responsible for the appropriations. For example, the Army may write a check to pay a Navy vendor and cite a Navy appropriation account.

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An effective reconciliation of DOD's and Treasury's records requires not only identifying differences, but researching and recording appropriate adjustments in the accounting systems. DOD has been unable to carry out these critical reconciliations because of

- at least \$4 billion in differences between checks issued by DOD and reported to Treasury,
- an indeterminable dollar amount of transactions in suspense accounts, which are to be used to hold transactions temporarily until the agency can determine the appropriate accounting treatment, and
- a reported \$22 billion in problem disbursements.

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## Differences in Checks Issued

DOD disbursing offices write thousands of checks daily to pay the Department's bills. Each month, the disbursing offices provide Treasury with an accountability report that shows the total amount of checks disbursed, by appropriation, for that reporting period. For the total reported amount of checks disbursed, offices provide Treasury with computer listings of individual checks written and their amounts throughout the month and after each month end. Treasury compares the accountability report totals to the total of the computer listings. Treasury also compares the individual checks on the computer listings to the individual checks that have been paid by the Federal Reserve System. Treasury reports any discrepancies to DOD for follow-up and correction.

Discrepancies between DOD records and Treasury records can occur because of the following situations: (1) the disbursing office makes an error in the accountability report, (2) the computer tapes are incomplete or are not processed by Treasury, and (3) DOD's recorded amount for a check is different from the amount that is paid by the Federal Reserve.

At September 30, 1997, DOD and Treasury records differed by more than \$4 billion—\$1.4 billion for Army, \$1.7 billion for Air Force, \$0.7 billion for Navy, and \$0.4 billion for other DOD components. However, this \$4 billion represents only the net difference of all the positive and negative discrepancies that existed at year-end. For example, any errors in reporting on accountability reports have been offset against errors caused by submission of incomplete computer check listings. Although auditors were unable to determine the total value of the discrepancies, it is likely to be much larger than the reported net amount.

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Because DOD had not performed a proper reconciliation with Treasury records, auditors were also unable to determine whose records needed to be adjusted for the differences. While some of these discrepancies could be timing differences, others could be due to errors in DOD recorded amounts or result from an error by Treasury. Furthermore, until these differences are identified, and it is determined whose records require adjustment, DOD is not recording these differences or maintaining control accounts to accumulate these amounts to ensure that all corrections are made.

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### Indeterminable Amounts Held in Suspense Accounts

In addition to the cash activity discussed above which is not being properly reconciled to Treasury's records, DOD is not properly reconciling its suspense accounts. DOD maintains suspense accounts to record receipt or disbursement transactions for which it is either unable to determine, or has not yet attempted to determine, the correct fund or appropriation citation. When the disbursing office cannot identify the correct fund or appropriation account to provide to Treasury for a receipt or disbursement transaction, the transaction is placed in a suspense account in both DOD's and Treasury's records. These suspense accounts are to be temporary holding accounts that are quickly cleared to permit proper accounting. Until the individual transactions are properly recorded, DOD's budgetary accounts, which tell DOD the status of its available funds, and its accounting records, which provide information on the cost of its programs and activities as well as its assets and liabilities, do not include this information and are therefore inaccurate.

At the end of fiscal year 1997, these suspense accounts totaled \$769 million when collections and adjustments were netted against all disbursements. However, this significantly understates the magnitude of the problem. For example, while the Navy had a net balance of \$464 million in suspense accounts recorded in its records, the individual transactions, collections as well as disbursements, totaled about \$5.9 billion. As a result of not properly recording the \$5.9 billion in transactions, the cost of individual programs and activities may be understated because of unprocessed disbursements, while the cost of other programs and activities may be overstated by the unprocessed collections. We have been working with DOD officials and auditors to identify actions DOD should take effectively address this issue in fiscal year 1998.

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## Problems in Accounting for Disbursements

Problem disbursements is the term used to refer to specific DOD disbursements that have not been matched with corresponding obligations and include the suspense accounts previously discussed as well as unmatched disbursements, in-transit disbursements, and negative unliquidated obligations.<sup>36</sup> Unlike suspense accounts, other problem disbursement categories have been charged to a particular appropriation account in Treasury and in DOD's records when the disbursement is made. However, as with suspense accounts, these other problem disbursement categories may not be reflected in the cost of DOD's programs and activities, nor properly reflected in DOD's status of funds because accurate accounting information beyond the appropriation is not available. While DOD has made progress in this area, it still faces a considerable challenge if it is to effectively resolve long-standing deficiencies.

In February 1995, at the date of our 1995 High-Risk report,<sup>37</sup> DOD reported \$25 billion of problem disbursements. In May of the following year, DOD reported a reduction in that balance to \$18 billion. Examining that reported balance, we issued a report in May 1997 which showed that the balance was understated by at least \$25 billion and should actually have been reported at over \$43 billion.<sup>38</sup> This occurred primarily because DOD was not reporting all transactions that needed to be resolved, but instead was offsetting collections and adjustments against unrelated disbursements.

In June 1997, DOD began reporting all of its problem disbursements without those offsets. At that time, it reported a balance of over \$31 billion in problem transactions. In its latest report, January 1998, DOD reported \$22.6 billion in problem transactions. DOD's reports for problem disbursements show that the decrease resulted primarily from actions to clean up old problems. For example, as of January 31, 1998, the Navy had discontinued research and recorded \$2.6 billion in obligations to reduce problem disbursements. While we have not tested DOD's January 1998 problem disbursement report, our work on the financial audit has raised questions about whether all problem disbursements are being reported.

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<sup>36</sup>Unmatched disbursements occur when disbursement transactions are received by the accounting station, but attempts to match them to an obligation are unsuccessful. In-transits are disbursements that have been reported to Treasury but have either not been received or have not been processed by the accounting station. Negative unliquidated obligations occur when disbursement transactions are received, matched to an obligation, and posted to the appropriation by the accounting station, but the recorded disbursements exceed recorded obligations.

<sup>37</sup>High-Risk Series: An Overview (GAO-HR-95-1, February 1995).

<sup>38</sup>Financial Management: Improved Reporting Needed for DOD Problem Disbursements (GAO/AIMD-97-59, May 1, 1997).

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We have ongoing work in these areas to determine the extent to which this is occurring and the effect on the financial and budgetary reports.

Because systems problems contribute to the volume of problem disbursements, DOD has identified seven technological initiatives as key elements of its efforts to improve the contract payment process.<sup>39</sup> However, as we reported in our May 1997 report, DOD has not performed the in-depth analysis necessary to fully determine the underlying causes of these problems and therefore identify the most effective solutions and rank specific reforms. As a result, as with its other initiatives, the extent to which these seven technology initiatives will resolve DOD's long-standing disbursement problems is unclear.

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## Critical Areas Must Be Addressed to Meet Financial Reporting Goals

We and the military service auditors have made hundreds of recommendations in the last 2 years alone to help correct DOD's long-standing financial management deficiencies. These recommendations have ranged from specific and detailed actions, such as system edits that could be implemented to prevent certain errors, to broad suggestions to reengineer entire segments of DOD's operations, such as developing a concept of operations for how the department plans to conduct its financial management operations now and in the future. Going forward, we believe that two key issues are critical to DOD's ability to achieve the wide-ranging reforms necessary to address its long-standing financial management deficiencies. Until DOD upgrades the skills of its financial personnel and successfully integrates and consolidates its information systems, the Department may be able to accomplish some slow incremental improvements as we have seen in the past, but the sweeping changes needed to ultimately resolve its long-standing problems will remain outside its grasp.

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## Establishing a Skilled Financial Management Workforce

One of the key issues facing DOD under the CFO Act is the need to ensure that its financial management staff has the knowledge and skills required to carry out the Department's complex financial management operations. DOD's challenge in this area has been increased by the new set of federal accounting standards and other recent legislative requirements, including the mandate now in place for the development of performance measures that will rely, in part, on financial data. These challenges have highlighted the critical need for targeted technical financial- and accounting-related

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<sup>39</sup>Financial Management: Seven DOD Initiatives That Affect the Contract Payment Process (GAO/AIMD-98-40, January 30, 1998).

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training to supplement the on-the-job experiences of DOD's financial managers, if DOD is going to have the cadre of financial managers needed to pass the test of a financial statement audit and comply with the CFO Act.

DOD estimates that it has about 32,000 financial management personnel. The Defense Finance and Accounting Service (DFAS), which employs about 15,000 of these individuals and had a fiscal year 1998 budget exceeding \$1.6 billion, is primarily responsible for managing the accounting and finance operations of one of the nation's largest and most complex entities. Adding to the difficulty of carrying out financial operations in DOD is the continuing effort to downsize DOD.

Because DOD did not have reliable workforce profile information (including formal education, professional work experience, training, and professional certifications) available, we conducted a recent series of studies to obtain information on key financial managers from five DOD organizations.<sup>40</sup> Our surveys covered over 1,400 financial managers identified by DOD and military service officials as being their key financial managers. They often served as (1) comptrollers, deputy comptrollers, or budget officers at DOD and military service headquarters or field activities and (2) managers of accounting or finance operations at the DFAS.

Over half (53 percent) of the key DOD financial managers who responded to our surveys had received no financial or accounting-related training during 1995 and 1996. One in five respondents had received no training at all during that time. In contrast, many state government and private sector organizations we surveyed placed a strong emphasis on training as a means of upgrading workforce knowledge of current financial management, accounting, and reporting requirements.<sup>41</sup> It was also noteworthy that some organizations set internal training requirements for their personnel, while others stressed—and sometimes required—professional certifications in their hiring and promotion decisions—a vehicle which would help ensure that personnel holding such certificates kept abreast of emerging financial management developments.

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<sup>40</sup>Financial Management: Profile of DOD Comptroller/CFO Financial Managers (GAO/AIMD-97-97, June 27, 1997); Financial Management: Profile of Air Force Financial Managers (GAO/AIMD-98-4, November 28, 1997); Financial Management: Profile of Army Financial Managers (GAO/AIMD-98-58, February 25, 1998); and Financial Management: Profile of Navy and Marine Corps Financial Managers (GAO/AIMD-98-86, April 15, 1998). We are finalizing our audit work on the profile of DFAS financial managers.

<sup>41</sup>Financial Management: Profile of Financial Personnel in Large Private Sector Corporations and State Governments (GAO/AIMD-98-34, January 2, 1998).

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In October 1997, based on its audit of the department's support operations that are intended to operate on a business-like basis, the DOD Inspector General reported<sup>42</sup> continuing pervasive weaknesses in the personnel area, including incomplete or no training, insufficient management oversight, and an inability to respond to a rapidly changing accounting environment. The Inspector General also pointed out the critical linkage between training and the successful introduction and use of new accounting systems. In addition, the DOD Inspector General's report documented a widespread failure of accounting personnel to understand basic accounting theories and principles that support transaction entries.

DOD leadership has acknowledged that it needs to improve the capabilities of its financial managers, and DFAS is developing a program intended to identify the kinds of skills and developmental activities needed to improve the competencies of financial personnel. In addition, officials with each of the military services told us that they have implemented or are planning a number of programs to enhance the skills and competencies of their respective financial managers. However, DOD could enhance its plans to improve the professional skills of its financial managers by taking actions to ensure that (1) all critical competencies are addressed and applied, not just to DFAS, but to all DOD financial personnel, (2) financial personnel receive a minimum amount of annual financial management technical training, and (3) a specific curriculum to support the competencies is developed.

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## Developing Integrated Financial Management Systems

In our recent report, we stated that the U.S. government has ineffective internal controls due in part to poorly designed financial systems. In addition, we noted that widespread computer control weaknesses are placing enormous amounts of federal assets at risk of fraud and misuse and exposing agencies' computer systems to exploitation by outside intruders as well as authorized users with malicious intent. Nowhere in the federal government are financial systems design and computer control weaknesses more challenging and more serious than in DOD. Furthermore, DOD's approach to dealing with the Year 2000 issue is seriously hampering DOD's chances of successfully meeting the Year 2000 deadline for mission-critical systems.

## Financial Systems Design

DOD has a vast number of financial management systems. In 1995, DOD had identified and reported on 249 financial management systems in its annual

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<sup>42</sup>A Status Report on the Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund for FY 1996, Audit Report of the Office of the Inspector General, Department of Defense (Report No. 98-002, October 3, 1997).



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financial systems inventory to OMB. By 1996, that number had declined to 217 financial systems. In the latest report for 1997, DOD indicated a continued decline to 156 financial systems. DOD's performance plan has a long-term goal of reducing the number of finance systems to 9 and, by fiscal year 2003, of reducing the number of accounting systems to no more than 23.

However, DOD does not identify and report on the total number of financial management systems it uses. Specifically, as we reported in January 1997,<sup>43</sup> DOD excluded major financial management systems, such as acquisition, logistics, and personnel systems, because they are generally not within the CFO (Comptroller) organization. In fact, the Army's (CBSX) and the Air Force's (REMIS) systems which provide information for financial reporting on a large portion of DOD's fiscal year 1997 \$635.5 billion in military equipment, are not included in those counts.

A comprehensive inventory of systems used to record, accumulate, classify, and report on DOD's financial management information is a critical step if DOD is to (1) effectively manage its existing systems, (2) prioritize and coordinate efforts to correct longstanding financial systems deficiencies, and (3) develop a reliable, integrated financial management system. Army and Air Force officials have indicated that they are in the process of identifying the "critical" systems that provide information to the finance and accounting systems owned and operated by DOD's accounting organization—the Defense Finance and Accounting Service.

In addition to not having a complete inventory of its financial management systems, DOD has not documented how it conducts its financial management operations now and plans to in the future. A concept of operations is needed to provide the foundation upon which the rest of the systems planning process is built. A concept of operations is a particularly critical step at DOD because of the organizational complexity of its financial management activities. According to the DFAS September 1996 Chief Financial Officer Financial Management 5-Year Plan, it is estimated that the DOD financial community is reliant on data captured by other functional areas, such as logistics and acquisition, for about 80 percent of the data used in its processes. Without careful planning that includes these other communities, system development efforts are likely to fail to meet DOD's needs. In recognition of this critical planning process, the 1998 Defense Authorization Act requires DOD to submit a concept of operations

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<sup>43</sup>Financial Management: Comments on DFAS' Draft Federal Accounting Standards and Requirements (GAO/AIMD-97-108R, June 16, 1997).

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as part of a biennial financial management improvement plan—the first of which is to be submitted by September 30, 1998.

Without adequate financial management systems, DOD's operations will continue to be burdened with costly, error prone systems that do not provide financial controls to ensure that DOD's assets are safeguarded, its resources appropriately used, or the cost of its activities accurately measured. In fact, the DOD IG recently concluded that DOD's financial systems did not meet the requirements of the Federal Financial Managers Improvement Act of 1996. DOD must, within 120 days of the DOD IG report, submit a remediation plan to OMB to address these deficiencies.

## Computer Security

Also, serious concerns exist over the security of the Department's computer systems containing unclassified information. In a 1996 report, which was limited in distribution because of the sensitive nature of the specific findings, we reported serious weaknesses that would allow both hackers and hundreds of thousands of legitimate users with valid access privileges to improperly modify, steal, inappropriately disclose, and destroy sensitive DOD data. That same year, we issued another report which stated that DOD experienced as many as 250,000 hacker attacks on its computer systems in 1995 and that 65 percent of the attacks were successful.<sup>44</sup> Based upon our work performed for fiscal year 1997, these vulnerabilities continue to exist. Specifically, computer controls do not provide adequate protection of significant financial applications involving personnel, payroll, disbursements, and inventory information maintained in DOD's computer systems. While DOD has corrected some weaknesses underlying our recommendations from prior reports—thereby improving controls—responses to the recommendations remain incomplete. DOD has announced its intention to develop and implement an integrated, comprehensive information assurance program by August 1998.

## Year 2000

DOD relies on computer systems for virtually all aspects of its operations, including strategic and tactical operations, weaponry, intelligence, and security. This reliance extends to its business operations that support the Department including financial management. Most of Defense's automated information systems are vulnerable to the Year 2000 problem, which is rooted in the way dates are recorded, computed, and transmitted in these

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<sup>44</sup>Information Security: Computer Attacks at Department of Defense Pose Increasing Risks (GAO/AIMD-96-84, May 22, 1996).

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systems.<sup>45</sup> Failure to successfully address the Year 2000 problem in time could severely degrade or disrupt any of these operations.

DOD faces a formidable task in providing assurance that its thousands of systems will be compliant and that the data exchanged among these systems will be accurate. At your request, we have issued a number of reports on the Year 2000 activities of several DOD components, and our comprehensive report will be issued later this month. We are concerned that the Department has not made adequate progress in addressing Year 2000 issues. While DOD has taken many positive steps to increase awareness and promote information sharing, it lacks key management and oversight controls to enforce good management practices, direct resources, and establish a good picture of overall progress in fixing key systems. As a result, the Department has increased its risk that errors will be propagated from one organization's systems to another's, that all system interfaces will not be thoroughly tested, and that all components will not be prepared to carry on essential business and mission operations in the event of system failures.

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## Future Prospects

DOD has a number of financial management reform efforts planned or underway. In our recent report on the first ever set of consolidated financial statements of the U.S. government, we noted that DOD had stated that it planned to complete a new accounting systems architecture, review its inventory accounting processes, and develop a departmentwide property accounting system. Also, OMB has recognized that resolving DOD's financial management difficulties is critical to the development of auditable consolidated U.S. government financial statements. As part of the President's Budget of the United States Government, Fiscal Year 1999, OMB identified, as one of its Priority Management Objectives, development of "a plan with specific milestones to obtain an unqualified audit opinion on Defense's financial statement." OMB's continuing strong oversight and support of DOD's efforts to put together and implement a well thought out, comprehensive plan for addressing DOD's many, serious financial management challenges is extremely important.

For our part, we will continue to work with DOD and OMB, as well as with the DOD Inspector General and each of the military service audit agencies, in further defining and identifying solutions for the many difficult financial

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<sup>45</sup>For the past several decades, DOD systems have typically used two digits to represent the year—such as 97 representing 1997—in order to conserve electronic data storage space. With this format, the computer cannot distinguish the year 2000 from the year 1900. Any uncorrected system using dates to compute or generate data will produce erroneous data or in some cases completely fail.

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management challenges the Department faces. We also plan to follow up on DOD's efforts to implement the numerous recommendations we have already made. For example, we have issued a series of reports on the factors to be considered and the data that must be available to meet accounting standards for Defense's environmental and disposal liabilities. Going forward, we plan to further evaluate Defense's property and logistical systems to recommend additional corrective actions to address weaknesses in accounting for major asset categories on the financial statements.

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In closing, Mr. Chairman, sustained congressional attention to the governmentwide implementation of financial management reform legislation now in place, such as that provided by this hearing, will be critical to instilling expected accountability in DOD and other agencies across government.

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

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# Related GAO Products

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

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**Related GAO Products**

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

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