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on

"Financial Management and Internal Control Challenges at the
Department of Defense"

Chairman Platts, Ranking Member Towns, and distinguished members of the Subcommittee, good morning and thank you for the opportunity to appear before you on behalf of the Department of Defense (DoD) Office of Inspector General (IG) to discuss the pervasive financial management challenges within the Department and improvements that must be made. While financial management challenges within the Department have existed for a long time, the current economic uncertainty and fiscal constraints make resolving these weaknesses critically important. These weaknesses prevent DoD from collecting and reporting financial and performance information that is accurate, reliable, and timely and readily available for senior leadership and other decision makers including the Congress. Over the past few years, the Department has worked diligently to address its financial management challenges and improve the quality of its financial management information. However, much more progress is required in order to be good stewards of the taxpayer's money and have reliable financial information for decision makers to use on a daily basis.

Today I will discuss DoD IG's perspective on the status of the Department's financial management challenges and the Department's efforts to resolve them. I will highlight critical areas that must be resolved before the Department can have auditable financial statements and reliable financial management operations. In addition, I will also discuss the challenges the Department continues to face in improving its financial management operations.

Before discussing the challenges, I would like to acknowledge the efforts of the Department's senior leadership, including the Honorable Robert Hale, the Under Secretary of Defense (Comptroller) and Chief Financial Officer, to reform financial management within the Department. Transforming the financial management of the Department is certainly no easy task and cannot be accomplished overnight. Comptroller Hale and his senior leaders have demonstrated a commitment to improving financial management and have recognized some of the impediments and actions necessary to improving the Department's financial management data, processes, internal controls, and related financial systems.

A measure of DoD's ongoing progress in the area of financial management is the ability to obtain unqualified opinions on supporting financial statements. Currently, there are 14 DoD entities that are required to prepare annual financial statements. Of the 14 DoD entities, two have achieved an unqualified opinion on their financial statements; the Military Retirement Fund and the U.S. Army Corps of Engineers Civil Works. In addition, there are 54 Other Defense Organizations general fund entities that are not required to prepare annual financial statements, but support the DoD Agency-Wide financial statements. Of the 54 Other Defense Organizations, the Defense Commissary Agency, Defense Contract Audit Agency, Defense Finance and Accounting Service, and the DoD IG have also received unqualified opinions.

In Fiscal Year 2010, the DoD IG audited the U.S. Marine Corps' (USMC) Statement of Budgetary Resources (SBR),¹ the first Military Component to undergo such an audit. This effort resulted in a disclaimer of opinion because the USMC was unable to provide timely and relevant supporting documentation for accounting transactions and could not provide evidence to support the reconciliations for key accounts and accounting processes were being performed regularly. However, the USMC and the Department are learning from this audit experience and some improvements have been identified during the Fiscal Year 2011 audit. Unfortunately, some of the same challenges encountered during the Fiscal Year 2010 audit have affected the Fiscal Year 2011 audit. For example, the USMC was unable to reconcile its Fund Balance with Treasury to detail transaction files during the Fiscal Year 2010 audit. The USMC provided detail transaction files in June of 2011, approximately 9 months after the start of the Fiscal Year 2011 audit. These detail transaction files are essential to support the reconciliation process. Further, the USMC has continued to struggle to provide timely and reliable supporting documentation during the FY 2011 audit. We will continue to work with the Department to identify obstacles and make recommendations to resolve barriers to achieving auditable financial statements.

¹ Report No. D-2011-009, "Independent Auditor's Report on the United States Marine Corps General Fund FY 2010 and FY 2009 Combined Statement of Budgetary Resources,"

PERVASIVE FINANCIAL MANAGEMENT CHALLENGES WITHIN THE DEPARTMENT

Since the 1990s, the DoD IG has identified financial management as one of several key challenges within the Department. DoD's financial management challenges are so significant that they constitute one of the largest impediments to the U.S. Government's ability to obtain an opinion on its consolidated financial statements.

The Department continues to face a myriad of problems that adversely affect its ability to provide reliable, timely, and useful financial and managerial data needed to support operating, budgeting, and policy decisions. Gaps in the financial framework impact the accuracy, reliability and timeliness of budgetary accounting and financial reporting. The most significant challenge for financial management within the Department is meeting the statutory mandated September 30, 2017, deadline to ensure that the DoD financial statements are validated as audit ready as required by the National Defense Authorization Act for Fiscal Year 2010.² In order to meet the September 2017 deadline, the Department must continue to aggressively pursue improvements in 1) data quality, 2) internal controls, and 3) financial systems. The Department may need to revise its initiatives and milestones as additional deficiencies and corrective actions are identified as a result of DoD's Financial Improvement and Audit Readiness (FIAR) process.

Currently, at least 13 material internal control weaknesses continue to exist including deficiencies in financial management and feeder systems; Fund Balance with Treasury; Accounts Receivable; Inventory, and General Property, Plant, and Equipment. Additional internal control weaknesses may be added as we continue to assess DoD's performance, progress, risk, and the impact of financial management challenges. These material weaknesses are pervasive and affect nearly all aspect of DoD's financial management operations. While 2017 may seem like a long time from now, as I will discuss later in this testimony, there is little margin for error. Any significant setbacks will likely jeopardize the Departments ability to meet this important date.

² Public Law 111-84, Section 1003, "Audit Readiness of Financial Statements of the Department of Defense"

DoD's strategy for improving its financial management operations is contained in the Financial Improvement Audit Readiness (FIAR) Plan. The Comptroller is responsible for preparing and issuing the FIAR Plan Status Report on a biannual basis. The FIAR Plan has continued to evolve since it was first issued in 2005. From Fiscal Years 2010 through 2016, the Department estimates it will spend almost \$11.4 billion to improve its financial management operations, including the development of Enterprise Resource Planning (ERP) systems.³ The current FIAR priorities, established in August 2009, focus on improving the processes, controls, and systems that support information used most often to manage the Department. Those financial improvements should assist in achieving an unqualified audit opinion and in demonstrating to the taxpayer that the Department is a good steward of the taxpayer's dollars. The May 2011 FIAR Plan Status Report focused on the Statement of Budgetary Resources and the existence and completeness of critical military assets.

The May FIAR Plan Status Report currently includes the interim detailed milestones and supporting efforts for making financial improvements in four key areas: 1) appropriations received, 2) Statement of Budgetary Resources, 3) existence and completeness of mission critical asset, and 4) ERP systems implementation. The FIAR strategy only addresses achieving an audit opinion on the Statement of Budgetary Resources and asserting audit readiness for the existence and completeness of assets by 2017. The FIAR Plan does not include the detailed milestones and supporting efforts necessary to achieve an audit opinion on the other three financial statements: Balance Sheet, Statement of Net Cost or Statement of Changes in Net Position.

KEY FINANCIAL MANAGEMENT AREAS FOR REFORM

Three key areas to financial management reform are improving the quality of the data, internal controls, and financial systems.

³ An ERP is an automated system using commercial off-the-shelf software consisting of multiple, integrated functional modules that perform a variety of business related tasks such as general ledger accounting, payroll, and supply chain management.

Data Quality. Reliable data are necessary to make sound business decisions. However, we frequently identify financial data that are unreliable, incomplete, and inaccurate. As a result, DoD managers often cannot reconcile financial data or rely on this data to make sound business decisions. Poor financial data also impedes the Department's ability to obtain unqualified financial statement audit opinions. Furthermore, unreliable data could result in improper payments or missed opportunities to collect debt owed to the Department. The DoD IG has consistently issued reports identifying problems with unreliable data. In Fiscal Year 2012, the DoD IG plans to announce audits on this topic that will continue to make recommendations to improve the reliability of financial data in the Department.

From Fiscal Year 2007 through Fiscal Year 2011, 89 DoD IG reports have identified data quality problems. For example, in our audit of controls over the Army Deployable Disbursing System,⁴ we found that the system did not maintain accurate lines of accounting, accurate payment methods information, or complete fundamental payment information such as invoice line item information. As a result, the Army lacked a complete audit trail and could not reconcile information between the Army payment and accounting systems for 296 of the 402 commercial payments we reviewed. Further, the Army could not provide a complete universe of commercial payments made through the system.

In another example, our review of the reporting of obligations and expenditures for the Guam Realignment,⁵ found that the Department did not provide reliable cost information to Congress regarding the Calendar Year 2009 Guam realignment costs. Specifically, obligations were understated by over 10 percent (\$7.3 million of the \$60.3 million) while expenditures were overstated by over 35 percent (\$13.3 million of the \$35.6 million). These errors were caused by personnel inputting incorrect amounts or account numbers into the financial management systems that were not detected and corrected during the normal course of business. Without complete and reliable data, the ability of senior

⁴ Report No. D-2011-101, "Controls Over Army Deployable Disbursing System," August 17, 2011

⁵ Report No. D-2011-075, "DoD Official Need to Improve Reporting of Obligations and Expenditures for the Guam Realignment," June 17, 2011

leaders and Congress to make well-informed decisions about this key military realignment is severely affected. In addition, the Department will not have reliable historical cost data for planning future military realignments.

Internal Controls. Internal controls are an integral part of an organization's management which are designed to provide reasonable assurance of achieving: effective and efficient operations; reliability of financial reporting; and compliance with applicable laws and regulations. Internal controls include the plans, methods, and procedures used to meet missions, goals and objectives. Internal controls also serve as the first line of defense in safeguarding assets and preventing and detecting errors and fraud. In short, internal controls help senior leaders and managers achieve desired results through effective stewardship of taxpayer dollars.

Since the mid-1990s, the DoD IG has reported numerous material internal control weaknesses⁶ that impact the Military Services' and the Department's ability to achieve an unqualified financial statement opinion. In our most recent disclaimer of opinion on the Fiscal Year 2010 DoD Agency-wide financial statements,⁷ we reported the following 13 material internal control weaknesses:

- Financial Management Systems;
- Fund Balance with Treasury;
- Accounts Receivable;
- Inventory;
- Operating Materials and Supplies;
- General Property, Plant, and Equipment;
- Government Furnished Material and Contractor Acquired Material;
- Accounts Payable;
- Environmental Liabilities;
- Statement of Net Cost;
- Intragovernmental Eliminations;

⁶ Department of Defense Agency Financial Report for Fiscal Year 2010, November 15, 2010

⁷ Report No. D-2011-011, "Independent Auditor's Report on the DoD Agency-Wide FY 2010 and FY 2009 Basic Financial Statements," November 15, 2010

- Other Accounting Entries; and
- Reconciliation of Net Cost of Operations to Budget.

Until the Department resolves these pervasive weaknesses, it will be very difficult for DoD to reliably assert that it is ready for audit by 2017.

Poor internal controls can have an adverse impact beyond DoD. For example, in April 2011, we reported on the absence of internal controls resulting in potential lost tax revenue as well as incorrect information regarding contractors support efforts in Southwest Asia. Specifically, we found that the Defense Finance and Accounting Service, the U.S. Army Financial Management Command, and the Financial Management Center did not establish standard operating procedures for Army Commercial Vendor Services personnel to correctly code the status of contractors or for Army Commercial Vendor Services offices to file Federal information returns.⁸ As a result, Army Commercial Vendor Services personnel incorrectly coded domestic contractors as foreign and did not take action to file Federal information returns for an estimated 316 incorrectly coded payments totaling \$351.92 million, to the Internal Revenue Service. Further, Army Commercial Vendor Services personnel did not comply with Federal laws to file Federal information returns, by not filing or using the Defense Finance and Accounting Service Tax Office to file returns to the Internal Revenue Service for 363 payments totaling up to \$37.54 million made to system-identified domestic contractors.

In addition, poor internal controls increase the risk of fraud, waste, and abuse. A joint investigation conducted by the Defense Criminal Investigative Service, Federal Bureau of Investigations, the U.S. Agency for International Development, and others disclosed that the Louis Berger Group, Inc., (LBG) a New Jersey-based engineering consulting company, charged inflated overhead rates that were used for invoicing on numerous government reconstruction contracts in Iraq and Afghanistan. From at least 1999 through August 2007, LBG intentionally overbilled the U.S. government, with an identified

⁸ Report No. D-2011-059, "Army Commercial Vendor Services Offices in Iraq Noncompliant with Internal Revenue Service Reporting Requirements," April 8, 2011

impact to DoD of \$70.9 million. The scheme was carried out by two former senior LBG employees who were responsible for ensuring the integrity of LBG's cost data used to calculate overhead rates that LBG charged the federal government. The contractor agreed to pay \$18.7 million in related criminal penalties and make full restitution to U.S. Agency for International Development. The civil settlement also required the company to pay the U.S. Government \$50.6 million to resolve allegations that LBG violated the False Claims Act. Although fraud is a deliberate act to deceive and circumvent controls, weak internal controls created an environment conducive to this fraudulent activity and the Department did not detect it in a timely manner.

Our audit work focusing on improper payments illustrates what can occur when the Department does not have adequate controls in place.

Improper Payments. Improper payments are often the result of unreliable data and poor internal controls. These conditions create an environment where fraud is more likely and, as a result, the Department lacks assurance that the billions of dollars in disbursements annually are made correctly. Simply stated, DoD does not consistently know that it is paying the right person, the correct amount, at the right point in time. An improper payment is any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Incorrect amounts are overpayments and underpayments made to eligible recipients (including inappropriate denials of payment or service, any payment that does not account for credit for applicable discounts, payments that are for the incorrect amount, and duplicate payments). An improper payment also includes any payment that was made to an ineligible recipient or for an ineligible good or service, or payments for goods or services not received (except for such payments authorized by law). In addition, when an agency's review process is unable to discern whether a payment was proper as a result of insufficient or a lack of documentation, this payment must also be considered an error.⁹

⁹ M-11-16, "Issuance of Revised Parts I and II to Appendix C of OMB Circular A-123," April 14, 2011

In Fiscal Year 2010, the Department reported nearly \$1 billion in estimated improper payments. However, based on our audit results, we are concerned with the accuracy and reliability of the Department's estimation process. Without a reliable process to review expenditures and identify the full extent of improper payments, the Department will not be able to improve internal controls aimed at reducing improper payments and improving financial management controls.

In our audit of the Department's review and reporting of improper payments, we found the Department's review process included less than half of the fiscal year 2010 first quarter gross outlays.¹⁰ Specifically, DoD did not review approximately \$167.5 billion of the \$303.7 billion in gross outlays for high dollar overpayments. Additionally, some overpayments that we or the Department identified were not reported, and the First Quarter FY 2010 High Dollar Overpayments Report did not include sufficient information about recoveries and corrective actions. The Overpayments Report was inaccurate and incomplete because the Comptroller and the Director, Defense Finance and Accounting Service, did not develop a sound methodology or perform adequate oversight for collecting and reporting comprehensive data.

Comptroller officials stated that the \$167.5 billion in outlays the Department did not examine for improper payments included internal and intragovernmental transfers. Those outlays were not subject to the OMB reporting requirements since the payments did not leave the Government. However, we later determined that Comptroller officials did not perform a reconciliation to determine whether these outlays were internal or intragovernmental transfers. A complete reconciliation is still needed to demonstrate that all outlays are being examined for overpayments and in order to accurately report the extent of the overpayments.

¹⁰ Report No. D-2011-050, "DOD Needs to Improve the High Dollar Overpayment Review and Reporting," March 16, 2011

The Department has a reported 75 percent recovery rate of the nearly \$1.3 billion for improper payments identified during 2004 through 2010.¹¹ While we commend the Department on aggressively pursuing recovery of identified improper payments amounts, unless DoD improves its methodology to review all its disbursements, it will continue to understate its estimate of overpayments and will likely miss opportunities to collect additional improper payments. However, based on our audit results, we are concerned with the accuracy and reliability of the Department's estimation process. Without a reliable process to review all expenditures and identify the full extent of improper payments, the Department will not be able to improve internal controls aimed at reducing improper payments.

We and other auditors continue to identify improper payments. For example, the Defense Contract Audit Agency estimated about \$6.4 billion of improper payments to contractors for the period from October 2005 to through March 2011.¹² These are costs paid to contractors that Defense Contract Audit Agency questioned because they do not comply with rules, regulations, laws and/or contract terms which meets the definition of an improper payment. These improper payments the audit agency identified are greater than the \$1.3 billion of improper payments the Department identified during 2004 to 2010.

The Department's financial management processes are not always adequate to prevent or detect improper payments. For example, in our recent audit of a contract supporting Broad Area Maritime Surveillance, we found DoD personnel did not validate that the contractor was entitled to \$329.3 million it received as of January 12, 2010.¹³ In this case, the contracting officer thought the Contracting Officer Representative was

¹¹ Defense improper payment recovery performance and figures are as reported on <http://paymentaccuracy.gov/>. DoD IG has not validated the reported Defense performance or figures. As required by Executive Order 13520 dated November 20, 2009, "Reducing Improper Payments," the U.S. Department of the Treasury, in coordination with the U.S. Department of Justice and Office of Management and Budget, established this website to create a centralized location to publish information about improper payments made to individuals, organizations, and contractors.

¹² DoD IG analysis of Inspector General, DoD Semiannual Reports to Congress, Appendix D, from October 1, 2005 through March 31, 2011. Figure cited excludes 10 percent of reported questioned cost as Defense Contract Audit Agency provides audit support to other Federal agencies and includes those questioned costs in its overall reporting figures.

¹³ Report No. D-2011-028, "Contract Oversight for the Broad Area Maritime Surveillance Contract Needs Improvement," December 23, 2010

reviewing contractor invoices; however, the Contracting Officer Representative never reviewed any invoices because she did not know it was her duty. Further, since mid 2009, the Defense Contract Audit Agency revoked the contractor's authority to directly bill the Government because of continuing systemic issues with the contractors billing system. Finally, the contractor invoices lacked any detail such as labor hours worked, travel incurred or items produced. When we received some details supporting these bills, we found that the Navy paid \$206,000 in questionable travel expenses such as for a golf outing and air shows in Paris, France, and Singapore.

See figures 1 and 2 for examples of inadequate information on invoices that were paid by the Department on this contract.

Figure 1.

COST VOUCHER (INTERIM)					
- CONTINUATION SHEET					
* = Required Fields					
Contract Number		Delivery Order		Voucher Number	
N0001908C0023				BVN0032	
Item No	Stock #	Unit Price	Unit of Measure	Qty. Invoiced	Amount
0001	NONE	\$22,627,631.34	EA	1	\$22,627,631.34
	Stock Type	ACRN			
	MG	AB			
	SDN				
	AAA				
	Description				
	COST PLUS ITEM				
TOTAL:					\$22,627,631.34

Figure 2.

COST VOUCHER (INTERIM)					
- CONTINUATION SHEET					
* = Required Fields					
Contract Number N0001908C0023		Delivery Order		Voucher Number BVN0039	
Item No	Stock #	Unit Price	Unit of Measure	Qty. Invoiced	Amount
0001	NONE	\$21,797,900.3	EA	1	\$21,797,900.30
	Stock Type	ACRN			
	MG	AB			
	SDN				
	AAA				
	Description				
	COST PLUS ITEM				
TOTAL:					\$21,797,900.30

In another example, for construction contracts in Iraq and Afghanistan, we found that the Air Force improperly paid a bill for \$24.3 million for labor that was not specified in the base contract. Further, we found that the Air Force did not adequately verify that the Department actually received the goods and services listed. During this audit, we also found that invoice reviews did not always occur. The invoices we examined showed multiple discrepancies. One invoice showed a local construction inspector had 630 billable hours in a 27 day billing period. That person would have had to work on average 23.3 hours per day.¹⁴

In 2008, we reported that Government contractors responsible for processing TRICARE overseas health care claims made duplicate payments and overpayments to host-nation providers and to TRICARE beneficiaries.¹⁵ As a result, we estimated that TRICARE Management Agency made inaccurate payments totaling \$14.6 million for overseas health care claims during Fiscal Year 2004 and Fiscal Year 2005. We projected

¹⁴ Report No. D-2010-078, "Air Force Use of Time-and-Materials Contracts in Southwest Asia," August 16, 2010

¹⁵ Report No. D-2008-045, "Controls Over the TRICARE Overseas Healthcare Program," February 7, 2008

TRICARE Management Agency could put \$29.7 million of Defense Health Program funds to better use during the execution of the Fiscal Years 2008 through 2013 Future Years Defense Plan by strengthening internal controls, establishing sound contract surveillance plans, and improving recoupment procedures.

The DoD IG has reported previously about the Department's "pay and chase" practice, where contractors are paid the billed invoice amounts before determining what the correct billing amount should have been. For example, in March 2011 the DoD IG reported that in a contract for subsistence items in Afghanistan, the Department made improper payments by overpaying a contractor \$25.9 million for materiel costs and potentially overpaying \$98.4 million for transportation costs.¹⁶ This occurred because the Defense Logistics Agency was paying the contractor provisional transportation rates for moving food in Afghanistan based on a verbal change order in August 2005. The Defense Logistics Agency continued to pay higher transportation costs even though in 2008, the Defense Contract Audit Agency issued its report questioning provisional transportation costs. The Defense Logistics Agency stated it will resolve the improper payment issues by December 31, 2011.

Enterprise Resource Planning Systems. In an attempt to standardize and develop an effective financial management process throughout the Department, DoD has embarked on various efforts to implement new financial management systems and associated business processes; eliminating over 500 legacy systems that cost hundreds of millions of dollars annually to operate. Those efforts involve implementing new Enterprise Resource Planning (ERP) systems that were capable of handling financial transactions throughout an event's life cycle. An ERP is an automated system using commercial off-the-shelf software consisting of multiple, integrated functional modules that perform a variety of business related tasks such as general ledger accounting, payroll, and supply chain management. These ERP systems should provide the integration needed to minimize system interface problems and provide greater DoD financial visibility. However, based

¹⁶ Report No. D-2011-047, "Improvements Needed in Contract Administration of the Subsistence Prime Vendor Contract for Afghanistan," March 2, 2011

on DoD IG's audits of the General Fund Enterprise Business System and the Logistics Modernization Program, two ERPs that are critical to Army business improvement efforts, it appears DoD may be facing serious challenges in implementing critical ERPs. These systems experienced implementation problems that resulted in incurred cost and schedule growth and the lack of appropriate senior-level governance over their development, test, and implementation.

For example, in 2008 we reported that the Army did not effectively plan the acquisition of General Fund Enterprise Business System integration services which places the program at high risk for incurring schedule delays, exceeding planned costs, and not meeting program objectives.¹⁷ The Army's primary objectives for developing the General Fund Enterprise Business System are to improve financial performance, standardize business processes, ensure that capability exists to meet future financial management needs, and provide Army decision makers with relevant, reliable, and timely financial information. In 2011, the DoD IG reported that the Army estimated it will spend \$2.4 billion over the General Fund Enterprise Business System life cycle; however, the Army had not identified all of the requirements and costs associated with the project. In addition, the Army used unsupported and incomplete lifecycle cost estimates to determine the \$1.4 billion in cost savings and the Army used an inappropriate methodology to determine the estimated \$3.9 billion in benefits for implementing General Fund Enterprise Business System.¹⁸

In another audit of the General Fund Enterprise Business System, we found the Assistant Secretary of the Army (Financial Management and Comptroller) did not provide a detailed data conversion plan. Data conversion is the modification of existing data to enable it to operate with similar capabilities in a different environment. It is a significant part of the financial system implementation in terms of workload, complexity, risk, and cost and is one of the most frequently underestimated tasks. Inadequate planning for data conversion processes may lead to long-term repercussions, including failure to meet

¹⁷ Report No. D-2008-041, "Management of the General Fund Enterprise Business System," January 14, 2008

¹⁸ Report No. D-2011-072, "Previously Identified Deficiencies Not Corrected in the General Fund Enterprise Business System Program," June 15, 2011

program objectives, such as producing auditable financial statements. The General Fund Enterprise Business System Program Management Office provided a data conversion guide; however, the guide did not address data conversion for at least 49 non-Army systems that process Army data. In addition, the guide did not mention how the General Fund Enterprise Business System Program Management Office plans to handle historical transactional data, other than it will not convert it. Without converting historical transactional data for appropriations such as indefinite, multi-year, and no-year funds, the Army could potentially be using the General Fund Enterprise Business System and the legacy systems concurrently for many years.

The Army has also had challenges implementing the Logistics Modernization Program as the Army Working Capital Fund's target system for resolving its long-standing financial reporting problems by modernizing Army logistics business practices and meeting future military readiness requirements. The Logistics Modernization Program provides funds management, weapon system life cycle management, and material supply and service management capabilities. The Army reported to Congress that the Logistics Modernization Program would be the Army Working Capital Fund's system solution for obtaining auditable financial statements. However, in a report in 2011, the DoD IG stated that after more than ten years in development and a cost of \$1.1 billion, the Army has failed to deliver a system that is U.S. Standard General Ledger compliant. Army and DoD financial communities did not establish the appropriate senior-level governance needed to develop, test, and implement the Logistics Modernization Program financial management requirements and processes needed to record Army Working Capital Fund financial data at the transaction level. As a result, Logistics Modernization Program was not substantially compliant with the Federal Financial Management Improvement Act of 1996. The system also did not resolve any of the ten Army Working Capital Fund internal control weaknesses. Therefore, the Army will need to spend additional funds to

comply with U.S. Standard General Ledger requirements and achieve an unqualified audit opinion on its Army Working Capital Fund financial statements.¹⁹

We currently have five ongoing ERP audits, which should provide insight on the status and effectiveness of DoD ERP implementation efforts and provide recommendations that may be useful to DoD managers in mitigating the risks associated with ERP implementation. For four of those five ERP audits, we are focused on evaluating whether the systems comply with the Standard Financial Information Structure. The objective of the remaining ERP audit is to determine whether the appropriate internal controls are in place within the system to record the accounting transactions related to the purchase of goods and services with verifiable audit trails. In FY 2012, we plan to audit two more ERPs and six systems that support DoD financial system improvement efforts.

CHALLENGES TO MEET THE 2017 AUDITABILITY REQUIREMENT

While the Department continues to improve its financial management processes, DoD is far from reaching an unqualified opinion and much more work needs to be accomplished to have auditable financial statements by the 2017 deadline. We have identified future risks that could impact the ability to meet the ambitious 2017 auditability requirement. These risks are: heavy reliance on ERPs; change to accounting standard, and key events that take place close to the 2017 deadline.

Effective ERP Implementation. The successful implementation of ERPs is critical for DoD to meet milestones and transform processes, internal controls and systems needed to provide useful, timely, and complete financial management data and to achieve auditability. The May 2011 FIAR Plan Status Report recognizes that auditability is dependent on successfully deploying ERP systems and interfacing them with other business and financial systems. However, the May 2011 FIAR Plan Status Report did not identify all ERPs and did not include milestones and costs for all ERPs. Additionally, DoD has been unable to meet key milestones for four of eleven Enterprise Resources

¹⁹ Report No. D-2011-015, "Insufficient Governance Over Logistics Modernization Program System Development," November 2, 2010

Planning systems in the Department. Specifically, we found that the Defense Agencies Initiative and the Integrated Personnel Pay System-Army are missing from the list although they are mentioned in other sections of the Plan. The Navy's Future Personnel and Pay Solution, is not in the FIAR Plan at all. As those ERP efforts slip, they may jeopardize the Department's ability to meet the 2017 deadline.

The development, implementation and effectiveness of these ERP systems are questionable at this point. The numerous interfaces between the ERP systems and the existing systems may be overwhelming and currently may not be adequately defined. Each interface presents a risk of the system not functioning as designed thus corrupting data or not exchanging data. The Department needs to ensure ERP system development addresses required business processes and functions and meets established milestones. Further, these systems must actually produce reliable data.

Proposed Change to Accounting Standard. Recording and depreciating the complete cost of assets, including military equipment, has been a long standing challenge for the Department. To resolve this issue, DoD plans to ask the Federal Accounting Standards Advisory Board to allow the Department to expense military equipment rather than record it on the balance sheet. Further, some systems such as the General Fund Enterprise Business System, Navy Enterprise Resource Planning, and the Defense Enterprise Accounting and Management System are being developed assuming this proposed change in accounting standard will occur. If the accounting standard is not changed, additional systems revisions will be necessary before DoD will be auditable. While we cannot speak on behalf of the Federal Accounting Standards Advisory Board, implementing changes in accounting standards often take a long time. The Department will need to work with the Federal Accounting Standards Advisory Board at the earliest possible time to ensure a decision can be made in time for the Department to meet the 2017 deadline and successfully implement the required system changes, if the standard is not changed.

Key Events Take Place Close to the 2017 Deadline. The milestones for the completing some critical financial improvement efforts reported in the May 2011 FIAR Plan Status Report are currently very close to the September 30, 2017, deadline for DoD to validate the financial statements are audit ready. As a result, DoD may not have adequate time to take corrective actions if additional deficiencies are identified, or if ERP implementations are delayed. For example, full deployment of Global Combat Support System - Army is planned for the fourth quarter of Fiscal Year 2017. Also, the Air Force and Defense Logistics Agency do not plan on asserting audit readiness of their Statement of Budgetary Resources until the first and second quarters of Fiscal Year 2017, respectively, and do not plan on completing a validation of this audit readiness assertion until the third and fourth quarters. The Other Defense Organizations do not plan on asserting audit readiness of the Statement of Budgetary Resources until the fourth quarter of Fiscal Year 2017 and do not include any validation of their audit readiness assertion. These milestones may not leave sufficient time for the Statement of Budgetary Resources to be independently verified as being audit ready. Further, because these entities are material to the DoD Agency-wide financial statements, any delay in those statements would likely prevent the Statement of Budgetary Resources, at the DoD Agency-wide level, from being audit ready.

CONCLUSION

Auditable financial statements allow DoD to demonstrate that it has significantly improved financial management over the billions of dollars it receives annually. Although, the Department faces some daunting financial management challenges that must be resolved, the Department continues to make progress in improving its financial management. There is much more to do in order to overcome the pervasive, long standing financial management problems that I have describe today. It is important to note that obtaining and unqualified opinion on DoD's financial statements are a means to a more important end. The real benefit of the financial statement audit comes from the improved data quality, internal controls and systems that make an unqualified opinion possible. Because of these improvements the Department is better positioned to have

accurate and timely financial information on a daily basis to ensure that every dollar supports the warfighters, improves military readiness, and is readily available to key decision makers.

Currently, the Department is devoting significant resources to address these challenges and we are encouraged by the progress they have made. We will continue to provide oversight of these efforts and make recommendations to help move the Department toward meeting their goal of becoming auditable by 2017.

This concludes my statement today and I would be happy to take any questions the Committee may have for me.