

July 8, 2004



Statement
of
Francis E. Reardon
Deputy Inspector General for Auditing
Office of the Inspector General
Department of Defense

before the
Subcommittee on Financial Management, the Budget and
International Security
Senate Committee on Governmental Affairs
on
“Department of Defense FY 2003 Financial Statements”

Department of Defense
Office of the Inspector General

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JUL 8 2004

The Honorable Peter G. Fitzgerald
Chairman
Subcommittee on Financial Management,
The Budget, and International Security
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510-6250

Dear Chairman Fitzgerald:

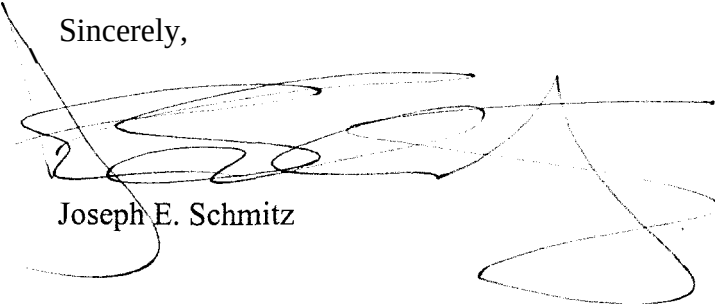
Thank you for your invitation to testify today's "Oversight Hearing on the Federal Government's 2003 Financial Statement: Improving Accountability of American Taxpayers' Dollars."

Being neither an accountant nor an auditor by background, I have endeavored as Inspector General to hire, train, and promote the very best accountants and auditors available to enable the Office of Inspector General of the Department of Defense to serve as an engine of positive change *vis-à-vis* the Department of Defense's satisfaction of the constitutional duty to publish "a regular Statement and Account of the Receipts and Expenditures of all public Money." At the same time, I have endeavored to develop close working relationships with the Auditors General of the Military Departments, "with a view toward avoiding duplication and insuring effective coordination and cooperation" (IG Act, Section 8(c)(9)).

Deputy Inspector General Gene Reardon is the best I have. Having reviewed his prepared testimony to your committee today, I would only reiterate that all of the professional auditors who serve in the Office of Inspector General of the Department of Defense are committed to do whatever we can to assist the Department in satisfaction of the constitutional duty to publish "a regular Statement and Account of the Receipts and Expenditures of all public Money" (U.S. Constitution, Article I, Section 9).

Of course, should you have any questions or concerns not addressed at your hearing today, I would be glad to address such questions or concerns in follow-up correspondence or testimony.

Sincerely,


Joseph E. Schmitz

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to discuss, first, the status of progress in achieving an unqualified (clean) audit opinion for the Department of Defense and, second, other areas of financial management within the Department. The Department's financial statements are the most extensive, complex, and diverse financial statements in the Government. The Department faces financial management problems that are long-standing, pervasive, and deeply rooted in virtually all operations. These financial management problems have impeded the Department's ability to provide reliable, timely, and useful financial and managerial data to support operating, budgeting, and policy decisions. The problems have also prevented the Department from receiving an unqualified opinion on its financial statements.

To address these issues, the Department has undertaken the ambitious task of overhauling its financial management systems and business processes. Although DoD has initiated a process to improve the reliability of its financial reporting and actions to correct previously reported weaknesses, most financial statements today remain unreliable and much work needs to be done. However, we are encouraged by the many current initiatives led by the Office of the Under Secretary of Defense (Comptroller/Chief Financial Officer) and senior financial managers within the DoD Components to correct long-standing problems in order to achieve a favorable audit opinion by FY 2007. We believe there is a chance of reaching this goal; however, what is most encouraging is the effort being expended to correct the Department's problems.

In order to adequately support the Department's goal of an unqualified audit opinion by FY 2007, we in the Office of the Inspector General put in place plans and actions to increase our financial auditing staff during the next three years. We also plan to issue several contracts with independent public accounting firms for financial and systems audit work as management asserts that their financial data is reliable and ready for audit. Over the next three years, the Department has reported that they could assert as being ready for audit over 100 lines, systems, or audit opinions. If the funding for our buildup

and contracting efforts is delayed until the Department asserts that the *entire* financial statements are reliable and ready for audit, it will be impossible to complete necessary audit work in a timely manner—thus further delaying a favorable audit opinion on the U.S. Government Annual Financial Report.

Opinions on Financial Statements for FY 2003

For FY 2003, we issued a disclaimer of opinion for the Department of Defense Agency-Wide Financial Statements because numerous deficiencies continue to exist related to the quality of data, adequacy of reporting systems, and reliability of internal controls. We also issued a disclaimer of opinion on all but two of the nine major DoD reporting entities included in the Department of Defense Agency-wide Financial Statements requiring an audit opinion. As in past years, the FY 2003 Military Retirement Fund's financial statements received an unqualified opinion. The newly established Medicare Eligible Retiree Health Care Fund received a qualified audit opinion for FY 2003.

The Department has taken aggressive actions to improve financial management and reporting during the past several months. However, the Department and we expect no change in the status of audit opinions for the FY 2004 financial statements for the major DoD reporting entities to be issued in November 2004.

Internal Control Deficiencies

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

The Department has readily acknowledged that many of its financial management and feeder systems do not produce adequate data to support various material amounts on the

financial statements. As a result of the Department-wide deficiencies in accounting systems and business practices, the Department is unable to collect and report financial performance information that is timely, accurate, and reliable. However, DoD is making progress in correcting and reducing the materiality of the weaknesses. In FY 2002, we reported 13 material weaknesses for the DoD Agency-wide financial statements. In FY 2003, corrective actions were taken to reduce major deficiencies related to problem disbursements and the reported military retirement health benefits liabilities. Let me briefly discuss the current material internal control weaknesses and the actions needed to correct these weaknesses.

1. **Financial Management Systems.** The Department has been unable to collect and report financial information that is timely, accurate, and reliable. DoD has numerous business systems performing a myriad of tasks, and many of these financial management systems do not comply substantially with federal financial management system requirements. In addition, there is little standardization across the Department. Multiple systems perform the same task, identical data are stored in multiple systems, data are manually entered into multiple systems, and there are many work-around and off-line records to translate data from one system to another. These characteristics limit data integrity and require extensive effort by management to compile financial statements. These system deficiencies affect many aspects of financial reporting.

Previously, we have reported—and management has acknowledged—that Department financial management systems do not substantially comply with federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. Additionally, we have reported that the Department's financial management and feeder systems cannot provide adequate evidence to support various material amounts on the financial statements. We have also recommended improvements to the Department's overall management of information technology, and that the Department improve the quality of information technology reporting to Congress and

the Office of Management and Budget, which would increase the usefulness of the information and demonstrate that the Department was effectively managing information technology investments.

In regard these issues, it is our opinion that that the Department's effort to address weaknesses in financial information systems with the Business Management Modernization Plan (BMMP) is a necessary and overdue step. In July 2001, the Secretary of Defense established the BMMP to transform and modernize the Department's business and financial processes and systems to optimize the efficiency and effectiveness of all DoD business processes—financial, procurement, logistical, and personnel. The overall goal is to transform the Department's business operations so that accurate, reliable, and timely business information is available on a routine basis to support informed decision-making at all levels in the Department. Although the BMMP is a long-term approach to the Department's financial management problems, one of the early objectives of the BMMP is to achieve an unqualified audit opinion on the FY 2007 DoD Agency-Wide Financial Statements.

Until the BMMP is in place, the Department will continue to use legacy systems to provide data for the FY 2007 DoD Agency-Wide Financial Statements. Even though the Department has much work to complete in this area, we believe that continued reviews of financial systems that will eventually be replaced or upgraded are necessary to ensure that reliable data are available to be transferred to the reengineered processes and systems and for effective business management now and in the future. Accordingly, we plan to perform, as funding is available, reviews of legacy systems to verify that the data in existing systems are reliable. We believe that the Department's efforts are focused on a plan to use BMMP initiatives information from legacy systems to deliver auditable information for financial statements. However, I again reiterate that audit processes are set up so that we will not expend taxpayer dollars unless we believe a favorable opinion can be delivered.

2. **Fund Balance with Treasury.** The FY 2003 DoD Fund Balance With Treasury account was approximately 22 percent of reported assets. During the year, more than

\$500 billion in funding flowed through the account—an increase from prior years. Despite the increase in disbursements, problem disbursements, although significant, continued to decline. However, differences continue to exist between the Department of Treasury and DoD disbursement records. Last year, we reported that the absolute value of the DoD differences was approximately \$20.6 billion. The Department has obtained legislative permission, which we supported, to clear old transactions prior to 2001 from its accounts when documentation is no longer available to support the transactions. This action should reduce the differences and gives us encouragement that the Department is making real progress in improving the reliability of this account.

Because of the number and complexity of the systems within the Department that support the Fund Balance With Treasury account, automated reconciliation is not possible. In light of these realities, we have recommended that DoD improve the reconciliation process and supporting systems as soon as possible. The Department and this office, as the responsible auditors, are making it a top priority, pending the availability of funds, to validate the reliability of data processed by the systems used to support the Fund Balance With Treasury account. Also, we expect both the Army and the Air Force to assert that their Fund Balance With Treasury accounts are ready for audit in early FY 2005.

3. **Inventory.** Inventory makes up about 5 percent of the reported assets on the Department's financial statements. The existing inventory valuation method does not produce an auditable approximation of historical cost because the associated gains and losses cannot be accurately tracked to specific items or purchases. Prior audit reports have identified inaccurate inventory records, deficiencies related to existence and completeness of inventory, and inaccurate inventory valuation. The Department has issued a contract to assist in transitioning inventory accounting to the historical cost method, and has established a working group with DoD Components to work through the impediments to obtain a favorable opinion by FY 2007. We continue to

work with the Department working group on these extremely complex issues and are supporting its efforts to resolve these deficiencies.

4. **Operating Materials and Supplies.** Operating Materials and Supplies makes up about 12 percent of total reported assets on the Department's Balance Sheet. Generally accepted accounting principles require that Operating Materials and Supplies be expensed as they are consumed. However, DoD accounting systems were designed to expense these materials when they are purchased rather than when consumed. In addition, significant amounts of Operating Materials and Supplies in the possession of contractors are not included in the Operating Materials and Supplies account balance. The Department included Operating Materials and Supplies in its contract to establish a supportable baseline for Inventory. The contractor is also evaluating how the Department can transition from the purchase method to the consumption method of accounting and how it can fully account for all of its Operating Materials and Supplies. The Department working group for Operating Material and Supplies is making progress as they work toward developing a proposed valuation methodology for establishing the baseline for historical cost that will support the valuation assertion. The final valuation methodology is due in December 2004, and the Department expects the implementation of the business enterprise architecture to correct reported weaknesses by the end of FY 2005. We continue to work with the Department to support their effort to develop a strategy to properly value and account for Operating Materials and Supplies.
5. **Property, Plant, and Equipment (PP&E).** Reported PP&E on the FY 2003 Financial Statements was more than \$446 billion, or almost 40 percent of total reported assets. The Department has acknowledged that PP&E is not reliably reported because legacy property and logistic systems were not designed to capture all costs or to calculate depreciation. The Military Departments are in the process of correcting weaknesses in property systems identified by auditors and improving processes and controls for property systems under development. For example, the Navy and the Air Force expect reported real property to be ready for audit during FY 2005, and we plan to begin audit coverage as assertions are made. We are also

working with each DoD Component and the General Accounting Office to ensure that a baseline for data for real and personal property is accurate and fully supported with source documents.

The task for achieving property balances that are accurately and reliably reported has been made much more difficult because of an FY 2003 policy change by the Federal Accounting Standards Advisory Board. This policy change requires the cost of Military Equipment to be reported on the Balance Sheet rather than as Required Supplementary Stewardship Information. The FY 2003 Agency-Wide Balance Sheet included a depreciated cost of \$325 billion for Military Equipment. We are working with the General Accounting Office and the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics to ensure that the Department's business rules, strategy, and approach to implement the new policy will meet generally accepted government accounting standards. The Department expects to complete the Military Equipment valuation by the end of FY 2006, and we are providing continuing audit coverage as they progress.

6. **Government-Furnished Material and Contractor-Acquired Material.** When it is in the best interest of the Government, the Department provides to contractors government property necessary to complete contract work. DoD has acknowledged that it is unable to comply with applicable requirements for reporting Government-Furnished Property and Contractor-Acquired Materials. The cost of DoD property and material in the possession of contractors is not reliably reported because of changes in accounting requirements and a lack of an integrated reporting methodology with industry. We are working with the Office of the Under Secretary of Defense (Acquisition, Technology, and Logistics), which is rewriting policy on property in the hands of contractors, to ensure that the policy will meet generally accepted accounting principles for Federal reporting entities and provide full accountability. The Department expects to correct this weakness by the end of FY 2005.

7. **Environmental Liabilities.** Reported environmental liabilities are about 4 percent of total reported DoD liabilities. DoD has acknowledged that environmental guidance, inventory of ranges and operational activities, and audit trails are incomplete, and that it has not recognized unamortized clean-up costs associated with PP&E. Our audit report D-2004-0080, “Environmental Liabilities Required to be Reported on the Annual Financial Statements,” May 5, 2004, showed that Army environmental estimates were unreliable because Army activities did not have effective controls in place to ensure adequate audit trails and documentation for supporting estimates. Furthermore, Army activities did not comply with established guidance when developing estimates and effective quality control programs had not been established. The Army has initiated actions to improve those controls and is also implementing a new feeder system to reduce the possibility of errors. The Deputy Under Secretary of Defense (Installations and Environment) has agreed to implement guidance to improve the development, recording, and reporting of environmental liabilities. The Military Departments expect all deficiencies to be corrected during FYs 2004 through 2006, and we will conduct audits as they assert that major portions of environmental liabilities are ready.
8. **Intragovernmental Eliminations and Other Accounting Entries.** DoD acknowledges that it makes unsupported adjustments with its trading partners because of the inability to reconcile most intragovernmental transactions with its trading partners. In addition, DoD acknowledges that it makes material amounts of unsupported accounting adjustments. The number and amount of unsupported adjustments have continued to decrease because the Department took corrective actions based on audit recommendations to improve the documentation supporting accounting adjustments. However, unsupported adjustments related to the inability to identify trading partners continue to be a major weakness. The Department of the Treasury is implementing a new Intragovernmental Management Control Plan to address this Government-wide material weakness. As part of our planned audit procedures for FY 2004, we will determine whether DoD complied with the plan’s new requirements. The Department expects to be able to reconcile intragovernmental

transactions and resolve the material weaknesses related to intragovernmental eliminations by the end of FY 2006.

9. **Statement of Net Cost.** Many of the Department's financial systems and processes were not designed to collect and record financial information on a full accrual accounting basis as required by generally accepted accounting principles. Therefore, transactions are generally recorded on a cash and budgetary basis. In addition, costs cannot be accumulated for major programs based on performance measures as required by the Government Performance and Results Act because current financial processes and systems do not capture and report this type of cost information. The Department has undertaken efforts to determine the actions required to bring its financial and non-financial feeder systems into compliance with generally accepted accounting principles. We are waiting for new systems and methodologies to be implemented before performing extensive audit work in this area -- the Department is aware of its deficiencies and is focusing on the most effective ways to make improvements. The Department has stated that the weaknesses will be corrected by the end of FY 2006.

10. **Statement of Financing.** The Department has acknowledged that it is unable to reconcile budgetary data to net costs. Specifically, budgetary data are not in agreement with proprietary expenses and capitalized assets. DoD disclosed in the notes to the FY 2003 financial statements that the Statement of Financing was adjusted by a net of \$12.5 billion to match the Statement of Net Costs. Also, the Department presented the Statement of Financing on a combined basis instead of a consolidated basis as required by the Office of Management and Budget because the Department is unable to perform the required intragovernmental eliminations. The current Treasury initiatives, when implemented, should help eliminate unsupported adjustments related to intragovernmental transactions. The Department expects that the implementation of the business enterprise architecture will correct this material weakness by the 4th quarter of FY 2006.

Congressional Guidance

Section 1008 of the National Defense Authorization Act for FY 2002 directed the Office of the Inspector General of the Department of Defense, when auditing the year-end financial statements, to perform only the minimum audit procedures required by auditing standards when management acknowledges that the financial statements are unreliable. We have long advocated that resources that are already scarce should not be expended to conduct complete audits that produce only a disclaimer of opinion at year-end. However, we strongly support and believe there are benefits to be gained by performing limited audits of current financial systems because data reliability must be ascertained before any opinion can be rendered.

We agree with the rationale behind Section 1008 and we have complied with those requirements in performing our audits of the FY 2003 DoD Agency-Wide Financial Statements and the nine other required reporting entities. We limited our audit procedures related to audit opinions commensurate with management representations that we received from the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer and the Military Departments. However, as the Department asserts that financial data is ready for audit, we must provide the required audit coverage, which will require additional resources.

The financial management weaknesses acknowledged by management during previous years and for FY 2004 enabled us to limit our audit work to issue disclaimers of opinion. We recognize, and have advised DoD management, that additional weaknesses may be identified in the future when we initiate detailed financial statement audit work in response to management's improved representations. However, as the Department continues to take corrective actions and improve systems and controls, we need to have trained audit staff available to promptly validate these actions in order to meet the Department's ambitious goal of achieving a favorable opinion for FY 2007. Our joint strategy with the Department is for us to audit specific lines items and financial statements as they become ready for audit, rather than waiting until all of the Department's problems are corrected, and is the best way to achieve optimal result.

Cooperation with DoD Management

I would like to mention that the Under Secretary of Defense (Comptroller)/Chief Financial Officer, as the Department's Chief Financial Officer, and his staff have a refreshing and unique open door policy to the OIG. The Office of the Inspector General, along with the Under Secretary of Defense (Comptroller)/Chief Financial Officer, realize that the lack of a favorable opinion on the Department's financial statements is a major impediment to the U.S. Government receiving an unqualified opinion on its annual financial statements. Without compromising our status as the independent auditor, the Inspector General, at the request of the Under Secretary of Defense (Comptroller)/Chief Financial Officer, is actively participating in discussions with senior leadership within the Department and within the Government on ways to help the Department achieve a favorable audit opinion. Additionally, we now participate in joint quarterly reviews of the Department's financial statements with the Under Secretary of Defense (Comptroller)/Chief Financial Officer and senior financial managers of the Military Departments to identify material issues that impact the quality of the Department's financial reporting process. It is on the basis of these meetings and our further involvement in more than 20 departmental audit committees that we are pressing forward with plans to build up our staff and resources to audit the Department as it prepares for a clean opinion in FY 2007.

In addition, I serve as a permanent independent advisory member on the recently established Financial Improvement Executive Steering Committee that includes the Deputy Chief Financial Officer, the Deputy Comptroller (Program and Budget), and the Director, Defense Finance and Accounting Service. The committee monitors and directs the progress of the DoD Financial Improvement Plan process. This committee also reviews, approves, and prioritizes those financial statement line items that DoD Components assert are candidates for assessment and audit.

The Under Secretary of Defense (Comptroller)/Chief Financial Officer has just finalized the financial improvement initiatives business rules to guide IG DoD and DoD

Components in determining when financial statements or line items are ready for audit. These business rules are designed to ensure that financial audits of specific line items and specific financial statements for DoD Components are only initiated when the specific Component has asserted that known deficiencies have been corrected. These business rules will help ensure that Government funds are used efficiently in compliance with Section 1008 of the FY 2002 National Defense Authorization Act. Of course, our ongoing audits to reduce waste and mismanagement within the Department are continuing.

Impact of the Inability to Prepare Auditable Financial Statements

The weaknesses that affect the auditability of the financial statements also impact other DoD programs and operations and contribute to waste, mismanagement, and inefficient use of DoD resources. These weaknesses affect the safeguarding of assets and proper use of funds and impair the prevention and identification of fraud, waste, and abuse.

Purchase Cards

You have expressed an interest in our work on the purchase cards and Government charge cards and we have done, and are doing, considerable work in these areas. Office of the Inspector General of the Department of Defense (OIG) personnel testified before the Senate Committee on Governmental Affairs on April 28, 2004, on “How to Save the Tax Payers Money Through Prudent Use of the Purchase Card.” At that hearing, we reported that purchase cards accounted for 25 percent of the purchase actions made in the Department in FY 2003. We presented the results of three OIG DoD audit reports issued in FYs 2003 and 2004, which identified management control problems with the use of purchase cards. At that hearing, we provided some of the following examples of questionable, inappropriate, or fraudulent purchases.

- One cardholder used the purchase card to make 59 fraudulent purchases totaling more than \$130,000. The purchases included two automobiles, a motorcycle, and cosmetic enhancements done through surgery. (“Summary Report on the Review of Selected DoD Purchase Card Transactions,” June 27, 2003, [IG DoD Report

No. D-2003-109])

- A DoD official was convicted of theft of Government property stemming from her use of the Government charge card to make about \$1.7 million of fictitious purchases from a fictitious firm. (“Selected Purchase Card Transactions at Washington Headquarters Services and Civilian Personnel Management Service,” October 16, 2003, [IG DoD Report No. D-2004-002])
- Approximately \$1.1 million of Space and Naval Warfare Systems Command, New Orleans Information Technology Center purchases were questionable because there was no obvious mission need for the items purchased. Questionable items purchased included six bicycles costing \$2,393 to be used by interns from New Orleans University in a non-existent intern program; three global positioning systems costing about \$1,720 for the Director to use because he routinely got lost when he went on travel; and luggage costing about \$700 that was purchased because the Director and his Deputy traveled frequently and needed to carry briefing papers. (“Purchase Card Use at the Space and Naval Warfare Systems Command, Information Technology Center, New Orleans, Louisiana,” November 14, 2003, [IG DoD Report No. D-2004-016])

We also discussed using data mining techniques and working with the Department to reduce costs related to prices on purchase card buys. However, this is an area where the Administrator of the General Services Administration (GSA) should take the lead. We feel that GSA, as a minimum, should establish a central data repository of charge card transactions for use by all Governmental agencies. This would eliminate or reduce costs for both the banks and Governmental agencies and ensure data could be shared. The central data repository could then be used to identify spending trends and help in the development of discounts across the Government. In addition, by having the data in one place, oversight agencies like GAO and the Offices of the Inspector General throughout the Government would not have to make additional queries of banks to obtain transaction information.

We also suggested that a Center of Excellence be established by the Government under GSA or associated with an educational institution staffed with experts who perform continuous research, develop training for users to be more effective buyers, negotiate point of sale discounts for all Federal agencies, and develop data mining tools and techniques to help all Federal agencies improve management of charge cards and, thus, reduce the potential for fraud, waste, and abuse.

Subsequent to the April 28, 2004, hearing, our office issued an additional report on purchase cards: “Controls Over Purchase Cards at the Naval Medical Center San Diego,” June 29, 2004, (IG DoD Report No. D-2004-096). We found no evidence of fraud. However, 52 of the 65 transactions we reviewed, valued at \$53,000, had one or more internal control weaknesses. Additionally, billing cycle limits were \$1.9 million higher than necessary for 18 of the 32 cardholders reviewed.

Travel Cards

We, along with GAO, also performed audit work on the travel card program. IG DoD Report No. D-2004-083. (“Management of the Centrally Billed Travel Card Program at Defense Agencies,” May 24, 2004) reported the following:

- Controls over centrally billed travel accounts were adequate at the Joint Chiefs of Staff, Defense Commissary Agency, Defense Security Cooperation Agency, and the National Defense University based on a review of documentation for the selected transactions. However, improvements were needed at the Travel Card Program Management Office and at Washington Headquarters Services.
- The Travel Card Program Management Office did not monitor centrally billed travel accounts. As a result, credit limits were about \$457 million higher than needed, and the Department was placed at increased risk for financial loss.
- Washington Headquarters Services did not properly establish and appropriately use a centrally billed travel account. For example, the Budget and Finance

Directorate opened five travel transaction accounts instead of using purchase cards and did not have adequate supporting documentation for purchases. As a result, non-travel related transactions, totaling about \$11,600, were processed on three of the five accounts. These transactions included purchases for art supplies, flowers, pen gift sets, receptions and meals, and a forklift. Travel-related charges of about \$158,400 were made and approved on these accounts without proper documentation. Additionally, the Director, Budget and Finance, Washington Headquarters Services did not always use the contracted Commercial Travel Office to provide required travel services. As a result, the Director, Budget and Finance violated the commercial travel office contract and the Joint Travel Regulation, and incurred excess travel expenses of about \$44,000.

We are currently working with the DoD Program Management Office for purchase cards to assist them in developing data mining indicators and tools to identify potentially fraudulent charges and situations discussed in these reports, so situations of this nature can be eliminated. We also are continuing to work with both the Purchase and Travel Card Program Management Offices to improve the programs, by reducing the financial risk to the Government, and offering recommendations to improve the Federal Managers Financial Integrity Act controls.

Other Audit Work

The Military Service audit agencies and we have also performed audits in many other areas. During the last semiannual report to Congress covering the six months ended March 31, 2004, the OIG DoD and the Military Service audit agencies issued 251 reports that identified opportunities for nearly \$1 billion in monetary benefits. These reports and more current reports issued during the past three months show our commitment to improving financial management and efficiency within the Department and reducing fraud, waste, and abuse at all levels. For example:

- The Air Force Audit Agency reported that a lack of system interfaces, data edits, and the inability of systems to identify certain types of transactions, in addition to

needed policy changes, contributed to the Air Force granting \$96.3 million in inappropriate credits (that is, customer refunds) to DoD customers who turned in spare assets to supply. The inappropriate credits deplete cash resources. By implementing the recommended corrective actions, the working capital fund's recurring negative cash position could be improved by at least \$578 million over the 6-year Future Years Defense Plan. (Air Force Audit Agency, "Credit Returns Management," October 22, 2003, [F2004-0001-FC4000])

- Lack of priority, attention, and resources and noncompliance with existing policies caused delays in closing contracts. At the Defense Finance and Accounting Service-Columbus, 1,084 contracts valued at \$2.9 billion remained open for 2 to 9 years while awaiting financial adjustment. The high numbers of outstanding contracts awaiting financial adjustments, including adjustments to resolve negative unliquidated obligations and potential overpayments, jeopardize DoD efforts to prepare financial information and statements that are auditable. ("Contracts Awaiting Financial Adjustments at the Defense and Accounting Service Columbus," October 24, 2003, [IG DoD Report No. D-2004-004])
- Lack of procedures to prevent manually processed invoices from being paid earlier than allowed by the Prompt Payment Act caused \$1.6 billion in payments to contractors to be made more than seven days prior to the due date. This potentially cost the U.S. Treasury an estimated \$1.5 million in lost interest. ("Early Payments of Invoices by the Defense Finance and Accounting Service Columbus," March 12, 2004, [IG DoD Report No. D-2004-058])
- The Defense Logistics Agency was purchasing new property items to fill requisitions while the same property items, in new or unused condition, were being disposed of and sold to a commercial contractor. DoD could have avoided costs of about \$9.2 million if the property items were used to fill open requirements instead of disposing of them. DoD could also increase revenues up to \$18.7 million if certain disposed items were sold back to DoD by the commercial contractor before being placed on auction. ("Defense Reutilization

and Marketing Services Commercial Venture Contracts for Privatization of the DoD Surplus Sales Program,” December 30, 2003, [IG DoD Report No. D-2004-037])

- An audit of Navy controls over material designated for or sent to the Defense Reutilization and Marketing Service showed that essential management controls needed improvement. As a result, \$39 million in acquisition costs of Government property that was not recorded on accountable supply records was vulnerable to loss or undetected theft, and resources could be expended unnecessarily in researching erroneous disposal transactions. (“Navy Controls Over Materiel Sent to Defense Reutilization and Marketing Offices,” June 24, 2004, [IG DoD Report No. D-2004-095])

In addition, we are currently working on several audits to identify and detect areas of fraud, waste and abuse, and mismanagement and to improve overall efficiency and effectiveness within the Department. For example,

- **Cash Management.** We are auditing, at management’s request, the cash management of the Foreign Military Sales Trust Fund.
- **Contract Financing Payments.** We are reviewing DoD accounting policy and procedures to determine whether they properly record and account for contract financing payments.
- **Erroneous Payments.** We are determining whether DoD identified and reported all programs and activities that may be susceptible to significant erroneous payments.
- **Overpayment to Deceased Retirees.** We are reviewing the process used by the Military Retirement Fund to suspend the personnel accounts of suspected deceased retirees upon receipt of a death notice and to recover any overpayments once a death is confirmed.
- **Prompt Pay.** We are reviewing DFAS Columbus vendor pay processes to determine whether they are in compliance with the Prompt Payment Act and DoD disbursing policies.

- **Charge Cards.** We have on-going projects on convenience checks, purchase cards, and premium travel. In addition, we are planning additional efforts in FYs 2005 through 2009 on the charge cards under the SmartPay contract.
- **Vendor Pay.** We are reviewing the Air Force General Fund vendor pay disbursement cycle to assess internal controls and compliance with laws and regulations.

Conclusion

As part of the effort to move forward and improve systems and business processes, the Department's leadership has provided increased access and cooperation to the OIG during the financial statement preparation and audit process. We especially want to thank the Under Secretary of Defense (Comptroller)/Chief Financial Officer and his staff for their relentless pursuit of the strategies needed to expedite the correction of the long-standing problems preventing the Department from receiving a favorable audit opinion. This strong leadership is the key element to successful financial management reform. We support the Department's commitment to successfully complete the numerous ongoing initiatives, and believe the Department is committed to continue to improve its systems, processes, and internal controls to ensure that financial information is accurately recorded and reported. The only viable approach to achieving a favorable audit opinion by FY 2007 is to provide incremental funding to audit individual line items and financial statements for each DoD Component when management asserts that deficiencies have been corrected. If funding for audit support to validate the Department's progress is not provided, the goal of achieving a favorable audit opinion by FY 2007 may be further delayed.

Thank you for considering the views of the Office of the Inspector General on financial management within the Department of Defense. This concludes my testimony.