

Statement

of

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before the

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Chairwoman Watson, Ranking Member Bilbray, and Members of the Committee, thank you for the opportunity to appear before the Oversight and Government Reform Committee as you continue your oversight of the Federal Government's consolidated financial statements. In representing the Department of Defense (DoD) today, I want to start by thanking the Members of Congress for their support of our men and women in the military. We cannot meet the nation's national security needs without your assistance.

Defense Financial Management Today

I was asked to speak with you about the results of DoD's financial statement audit for Fiscal Year (FY) 2009. As you are well aware, the Department continues to receive a disclaimer of opinion on the consolidated financial statements. Progress has been made, but major challenges remain that impede us in achieving an unqualified audit opinion. I'll discuss some of those impediments, as well as the key material weaknesses that continue to exist, and our recently revised priorities for improving the quality of financial information that we report.

To begin with, our systems are old and handle or exchange information in ways that do not pass current audit standards. This is an inherent problem that has developed through the years as a result of growing DoD business operations within a large decentralized organization that is both mission (vs. business) oriented and functionally "stovepiped." The legacy systems are not integrated and they do not consistently collect data at the transaction level. This leads to business processes that tend to be non-standard, often lacking effective financial controls. In these cases, the consistent application of required internal controls becomes critical. The organizations and financial entities within DoD that have achieved auditability have been small enough to be able to overcome these deficiencies.

The scale of business operations exacerbates these challenges. DoD's enormous size and geographical dispersion also greatly complicate the challenges associated with meeting audit standards. Every business day, we obligate an average of \$2 billion to \$3 billion and handle hundreds of thousands of payment transactions. Some of these financial transactions take place in war zones. Because of our size and mission requirements, it would be prohibitively costly to deploy an army of accountants to solve our problems manually. This is why our current effort supporting DoD business transformation is so critical, including the recent development of a business enterprise architecture, along with the implementation of modern, compliant systems. We need a more disciplined, automated business environment to cost-effectively maintain the necessary controls. In the meantime, we are also addressing our current material weaknesses.

Addressing Auditor-Identified Weaknesses

The Department continues to make progress toward achieving auditability. The auditor's report on DoD's financial statements includes descriptions of several material financial reporting weaknesses. The Department is following a revised strategy to address these weaknesses and improve financial and management information. I will discuss the revised strategy in more detail later, but would like to specifically describe some of the efforts to fix these weaknesses now.

- **Property, Plant and Equipment (PP&E) and Related Inventories.** The Department maintains the majority of total property in this category across the federal government. The inability of the Department's legacy systems and processes to identify, capture and

report the full cost of PP&E—along with the lack of sufficient supporting acquisition documentation—results in unreliable asset information. To meet the most pressing needs of the Department for effective management of PP&E and support of the warfighter, the Department has developed and is executing a plan of action to validate the existence and completeness of mission-critical assets as a first priority. These assets include Military and General Equipment, Real Property, Inventory and Operating Materials and Supplies. This means that we are performing physical inventories to support our accountable property records and to ensure mission-critical property is properly recorded, to include transactional audit trails.

- We will then make full use of a new accounting standard issued by the Federal Accounting Standards Advisory Board allowing estimates for valuing property. The new accounting standard will reduce the cost of the Department's efforts to eliminate the PP&E material weakness. In addition, the Enterprise Resource Planning Systems (ERPs) being implemented by the Military Departments can potentially provide the capability to capture and report the cost of PP&E and inventories.
- **Environmental and Disposal Liabilities.** The Department's internal controls for reporting environmental liabilities do not provide reasonable assurance that clean-up costs are fully identified, consistently estimated, and appropriately reported. The Department is fully committed to identifying and disposing of its environmental liabilities and has invested significant effort in improving policy and guidance, business processes, training and cleanup cost estimate procedures. Recent results have been encouraging. During 2009, the Army revised its environmental liabilities for demilitarization of chemical weapons based on updated costs. The Navy also received a favorable audit review from the DoD Inspector General on the weapons systems component of environmental and disposal liabilities. The Navy also asserted audit readiness of the Defense Environmental Restoration Program, Other Environmental Liabilities, and Base Realignment and Closure components of environmental liabilities. Finally, all Military Services began recognizing asbestos clean-up costs in 2009.
- **Military Healthcare Liabilities.** Weaknesses in financial processes related to coding for patient visits to military treatment facilities negatively impact the accuracy of these costs. As a result, this information cannot be relied upon to produce reliable reports and estimates of military health care liabilities. While implementation of new business systems should strengthen these processes in the long-term, the Department is considering revising the method of estimating health care liabilities. This alternative would use pre-established standard rates per patient, based on payment practices used by commercial health care providers to compute the health care liabilities instead of the current complex formula. These estimates should resolve the specific reporting weakness and permit the federal government to more accurately report these liabilities.
- **Fund Balance with Treasury.** DoD is unable to consistently reconcile account balances with Treasury at the transaction level across the Department. Legacy feeder systems capture and report business events and pass the related financial information to accounting systems. However, minimal front-end edits make data quality maintenance difficult. In some cases, these systems do not always pass transaction-level detail to the financial systems, or that detail is not maintained in the financial general ledger. To

address these weaknesses in the near term, the Department is implementing an automated transaction reconciliation capability for each Service as well as one for the Defense Agencies. These reconciliations, combined with supporting documentation, will allow the Department to balance its accounts with Treasury without making unsupported adjustments. This approach is beginning to show results. For example, the Navy will expand its existing reconciliation capability to include all transaction types and systems while also testing for completeness of supporting documentation. The Marine Corps is already demonstrating this capability as part of its FY 2010 audit. The Air Force plans to use its automated capability to reconcile all appropriations, beginning with FY 2008, which will ultimately support the required transactional reconciliations. Reconciliation of these accounts requires historical records supporting individual transactions that may be difficult or impossible to obtain.

- **Intragovernmental Eliminations.** DoD is unable to reconcile buyer and seller intragovernmental transactions because of limitations in the data available in DoD legacy accounting systems and data quality issues. Our federal government trading partners also have similar issues, resulting in differences and adjustments that cannot be verified. The Department is working initially with our largest trading partners to develop a framework for data exchange as an interim (but manual) solution focused on reducing intragovernmental differences in the near term. We are also collaborating with Treasury, the Office of Management and Budget (OMB), and our trading partners to develop and implement common solutions based on standard business processes, data elements, and systems that capture the transaction level detail needed to reconcile intragovernmental activity.
- **Unsupported Accounting Entries.** This weakness is a reflection of many of the weaknesses that have already been discussed. Current business rules that are required to prepare consolidated statements in this very challenging legacy environment result in adjustments that cannot be properly supported at a transaction level, as an auditor would expect to see. For example, intragovernmental activity is a root cause for many of these adjustments, as are legacy systems that cannot maintain both budgetary and proprietary ledger postings. Our solutions for all weaknesses now focus on posting and maintaining transaction-level detail that will minimize these entries.

Our current disclaimer of opinion reflects the inherent weaknesses of a business environment that is badly in need of modernization. We are partnering with the Department's Chief Management Officers to implement more effective business systems and engage functional leaders across the enterprise to effect meaningful change. A significant initiative is the DoD's Financial Improvement and Audit Readiness (FIAR) effort that focuses on improving the quality and accuracy of the data used for management decisions. While not all of the material weaknesses directly relate to the priorities of the FIAR effort, we are committed to addressing the remaining material weaknesses to achieve an unqualified opinion.

Our New Approach—Improve the Quality of the Information We Use Every Day

This approach was instituted a year ago by DoD's new Under Secretary (Comptroller) and CFO. He was convinced that the Department lacked a common goal or priorities in the audit readiness area. Instead, the Military Departments were pursuing their own initiatives and doing so with widely varying

degrees of commitment and resources. With this approach, he concluded that the Department, as a whole, would never achieve success. Also, the Department's dates for achieving audit readiness were not credible. Even the staff did not believe them.

Shortly after taking office, our CFO began consultations regarding a new approach with senior leaders in his office and in the Military Departments and Defense agencies. We also discussed a new approach with OMB, the Government Accountability Office, and some staff members in the Congress. In August of last year, a memorandum was issued outlining the new approach. It focuses on improving the quality, accuracy and reliability of the financial and asset information we use every day to manage the Department. Specifically, we plan to focus on two types of information—budgetary information and existence and completeness of assets.

Budgetary information is critical to leadership at all levels—program managers, program executive officers, base commanders, Service Chiefs, Service Secretaries, and the Secretary of Defense—as they make operational and resource allocation decisions. Our new approach focuses on improving budgetary information, which should lead to audit readiness for our Statements of Budgetary Resources.

The financial audit elements of “existence and completeness” translate directly into knowing what weapons and equipment we have, and their locations, so we can use this equipment in combat and ensure that our acquisition community is buying only what DoD needs. Existence and completeness, key financial audit elements for our balance sheet assets, represent the second priority area under the new approach.

The FY 2010 National Defense Authorization Act accommodates this new approach in the audit readiness legislation. We appreciate the support of the Congress for our new approach, and we have taken steps to implement it:

- First, we placed a reasonable priority on the effort. Financial improvement and audit readiness must be an agency-wide priority that has the support of senior leaders. This initiative is now one of DoD's top-ten business priorities.
- Second, we created a governance structure. We have a governance board chaired by the CFO that meets quarterly and includes the Deputy Chief Management Officers (CMOs) throughout the Department. The Chief Management Officer of the DoD and each of the Service CMOs have been briefed on this topic. I personally conduct weekly meetings with the heads of financial operations in the Military Departments, and these meetings regularly discuss issues related to financial improvement and audit readiness.
- Third, we obtained resources. Nothing is harder to do in DoD than acquiring resources for business process improvements, because these dollars compete, as they should, with direct warfighter needs. But we ensured that increased resources are devoted to high-priority financial improvement efforts, including business operations in Afghanistan.

- Fourth, we made improvement of audit readiness among individual DoD components a DoD High-Priority Performance Goal, with progress measurements described in the President's FY 2011 Budget's Analytical Perspectives volume.

To demonstrate progress, our plan includes interim goals that can be achieved by FY 2012. We plan a DoD-wide examination and validation of our funds control and distribution process (known in audit terms as “appropriations received”). Periodic validation of appropriations received will reassure the Congress that we are controlling our funds carefully and in ways that ensure we comply with the laws you enact. A clean opinion on the FY 2010 Marine Corps Statement of Budgetary Resources is a key interim goal. We will learn much from this effort. We have asked the Military Departments to identify areas that can be validated by FY 2012, including audit readiness for fund balance with Treasury.

We owe the Congress more detail on our plan. The FY 2010 National Defense Authorization Act requires that the CFO provide a semi-annual report on financial improvement and audit readiness in May and November. We are currently finalizing the May 2010 report, which will provide considerably more detail.

The FY 2010 National Defense Authorization Act not only requires reports; it requires DoD to have fully auditable financial statements by 2017. Under current audit rules, meeting that date would require the expenditure of large sums of DoD dollars to acquire and improve information. My understanding is that non-defense financial managers are also expressing concern about the costs of maintaining certain information in audit-ready status—information that is rarely used to manage. The CFO Council is reviewing alternative federal reporting models that may increase transparency while maintaining sound internal controls. After that review is complete, and after consulting with the appropriate stakeholders, we expect to identify and report to the Congress on a feasible approach to achieving fully auditable statements. For now, we are focusing on improving the financial information that we use to manage and the foundation that we are building—sound internal controls and implementation of more capable business systems—to support future auditability requirements for both DoD and the consolidated federal government financial statements.

Conclusion

As we look ahead and implement this new approach, we believe it is important to recognize the existing strengths within Defense's financial management. Most importantly, Defense financial managers are successfully providing DoD's warfighters with the resources and financial services necessary to meet our national security objectives. We are doing this around the world, including in Afghanistan and Iraq. Additionally, we have sound and effective financial processes in key areas. Our payment processes produce timely and accurate payments in a very high percentage of cases. Interest payments have been dramatically reduced in recent years, and our summary reconciliation rates with Treasury are very high. DoD also has a sound process for funds control and distribution, which has been periodically validated by external auditors. This validation ensures that funds are distributed in compliance with laws and regulations. After distribution, laws that are regularly enforced require that funds be obligated exactly as distributed. I believe this should reassure the Congress that DoD is spending its appropriations in accordance with the laws you enact. Our ongoing effort to improve the quality of financial information will build on these strengths while also supporting the elements of financial auditability that will be reflected in improved financial reporting. We need this to reinforce the

confidence of our stakeholders in our stewardship over government funds.

Moreover, we need to make improvements in DoD financial management while continuing to provide strong budget and financial information to our warfighters. I want the Committee to know that I am personally committed to this effort, and we will produce results that better support our national security mission and contribute to resolving material weaknesses that currently preclude a clean opinion on the federal government's consolidated financial statements.