



United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-253124

April 27, 1993

The Honorable Les Aspin
The Secretary of Defense



149062

Dear Mr. Secretary:

We have reviewed the Department of Defense's (DOD) fiscal year 1992 report mandated by the Federal Managers' Financial Integrity Act of 1982 (FMFIA). This report asserts that DOD's internal controls and financial systems, when taken as a whole, provide reasonable assurance that the objectives of the FMFIA are being achieved.

These assertions are inconsistent with details in DOD's report and with findings presented in a number of audit reports by GAO and others on DOD's financial management systems and operations. These reports highlight long-standing management, internal control, and accounting system deficiencies that weaken DOD's ability to safeguard, manage, and control the hundreds of billions of dollars of resources entrusted to it.

A summary of the major internal control and financial management deficiencies is provided in our high-risk and transition series reports issued in December 1992.

We are concerned that DOD's FMFIA report, which was issued shortly before you became Secretary of Defense, may lead you and other members of the new administration to overly optimistic conclusions about what should be done to correct the serious management, control, and accounting deficiencies of DOD. Should this happen, your ability to provide proper stewardship over DOD and effectively manage its operations will be severely impaired.

We note that you have recently directed the Deputy Secretary of Defense and the Comptroller's organization to review the Defense Business Operations Fund (DBOF). We think this action is an important step, but would point out that our concerns go well beyond the operations of this Fund to

GAO/AFMD-93-61R DOD's FMFIA Assertions

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include the need to put in place the right top executive leadership in DOD's financial and information management organizations.

The enclosures to this letter explain and illustrate our concerns. We hope that you will read them and meet with us soon to discuss the many important corrective actions that need to be taken, including strengthening DOD's management resources. Please call me on (202) 512-5500 or Donald H. Chapin on (202) 512-2600 to arrange for a meeting.

We are sending copies of this letter to the Director, Office of Management and Budget and to the Chairmen and Ranking Minority Members of the House and Senate Armed Services Committees, the Senate Committee on Governmental Affairs, the House Committee on Government Operations, the House Committee on Appropriations, and the Senate Committee on Appropriations.

Sincerely yours,



Charles A. Bowsher
Comptroller General
of the United States

Enclosures

DOD'S FISCAL YEAR 1992 FEDERAL MANAGERS'FINANCIAL INTEGRITY ACT REPORT IS MISLEADING

The FMFIA and its implementing guidance require the heads of federal agencies to annually report to the President and the Congress by December 31 whether (1) their internal control systems are effective, (2) their accounting systems conform to the Comptroller General's accounting principles and standards and related requirements, and (3) they have planned and/or implemented actions to correct identified weaknesses. Most importantly, the FMFIA process makes agency management responsible for assessing its own operations, and produces vital information that top management must have to control costs and improve operations.

The current environment of budget reductions and downsizing makes it more important than ever before that DOD achieve effective financial management and control over its operations. Effective financial management and controls can help DOD ensure that it gets the most value for each taxpayer dollar spent, thereby assuring that available budgetary resources will be used in ways to optimize readiness and force structure. The FMFIA process--by requiring identification and disclosure of existing weaknesses--provides an important tool and a vital first step to achieving the kinds of management reform needed.

Over the last few years, we have issued many reports¹ pointing out DOD-wide problems related to internal controls and accounting systems. In December 1992 we issued a series of high-risk² and transition³ reports which summarized these DOD-wide problems. The investigative and reporting process mandated by FMFIA should provide DOD with a powerful tool to identify additional internal

¹See enclosure II.

²High-Risk Series: Defense Inventory Management (GAO/HR-93-12, December 1992); Defense Contract Pricing (GAO/HR-93-8, December 1992); and Defense Weapons Systems Acquisition (GAO/HR-93-7, December 1992).

³Transition Series: Financial Management Issues (GAO/OCG-93-4TR, December 1992); and National Security Issues (GAO/OCG-93-9TR, December 1992).

control and accounting systems problems, and provide a basis for dealing with them in an organized fashion.

Unfortunately, DOD's fiscal year 1992 FMFIA report does not sufficiently and clearly disclose the extensive and deep-rooted weaknesses in its internal control systems or the widespread failure of its accounting systems to effectively comply with the applicable principles and standards. The report presents contradictory information that simply does not communicate present conditions. Furthermore, it presents planned corrective actions that often do not address the root causes of problems.

These conditions are not new to DOD; changing them will require a strong, knowledgeable, and seasoned financial management team at DOD. In this regard, the start of a new administration presents a unique opportunity to appoint the kinds of knowledgeable financial and information systems executives and managers that will be critical to achieving major management reform at DOD.

REQUIREMENTS FOR ANNUAL AGENCY FMFIA REPORTS

According to FMFIA and the implementing Office of Management and Budget (OMB) guidance,⁴ annual agency reports are to be based on self-assessments of agency internal control and accounting systems. The annual reports must state whether

- the agency's internal controls taken as a whole provide reasonable assurance that (1) obligations and costs are in accordance with applicable laws, (2) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and (3) revenues and expenditures are properly recorded and permit the presentation of reliable financial and statistical reports; and
- the agency's accounting systems conform to the Comptroller General's accounting principles and standards.

Agency reports must also identify any material internal control weaknesses or instances of nonconformity with the Comptroller General's accounting principles or standards. Finally, the report must describe the corrective actions to deal with current material weaknesses and noncompliances, and its efforts to

⁴OMB guidance in this area includes Circular A-123, "Internal Control Systems"; Circular A-127, "Financial Management Systems"; and annual memoranda issued to agencies.

validate whether corrections of past weaknesses and noncompliances are effective.

FISCAL YEAR 1992 REPORT OVERSTATES
THE EFFECTIVENESS OF DOD'S INTERNAL CONTROLS

In its fiscal year 1992 FMFIA report, DOD asserted that its internal controls, taken as a whole, provide reasonable assurance that the objectives of the FMFIA are being achieved. DOD asserted that the results of its 1992 internal control evaluations supported its assessment. DOD further asserted that audits of its financial statements and related notes have, with few exceptions, indicated that internal controls in DOD financial systems are adequate and that most financial system internal control weaknesses were not material.

In our view, the FMFIA evaluations and audit results that DOD relied upon offer overwhelming evidence that DOD's internal controls are not adequate. DOD's report acknowledges 116 material internal control weaknesses that cover major DOD resource areas such as contract administration, major system acquisition, and property management. Furthermore, many of our recent DOD financial audit and other reports (listed in enclosure II) show that DOD's financial and internal control systems do not adequately safeguard billions of dollars of resources, such as equipment and inventories. We have also identified extremely serious accounting control weaknesses in all three military services' operations, as well as in Defense Business Operations Fund activities. Several of the major findings from our reports follow.

Army

Our recent audit of Army's fiscal year 1991 financial statements uncovered major internal control weaknesses and accounting deficiencies that put billions of dollars of Army resources at risk of waste and mismanagement and prevented us from expressing an opinion on the financial statements. These included the following:

- The Defense Finance and Accounting Service (DFAS) initiated and processed about \$250 billion in adjustments to the data before preparing the Army's financial statements. However, officials could not give us records or documentation to support many of the adjustments and, where documentation was available, there was no evidence of supervisory review and approval.

- We could not verify the accuracy of equipment accounts reported to be \$151 billion because accounting policies on valuing items were not consistently followed.
- About 35 percent of the recorded inventory quantities at Army depots were inaccurate by 10 percent or more for the reported \$12 billion in inventory.
- Army has not established property accountability and controls over the \$7.4 billion in government material and equipment furnished to contractors.
- About \$18.4 billion of ammunition inventory held in central storage areas at installations was not recorded in accounting or logistics records. Also, about \$800 million of ammunition inventories either in transit or in production was not tracked and controlled through accounting or logistics records.
- Inadequate physical protection of hundreds of millions of dollars of weapons and equipment stored outside at Army depots resulted in some scrappage rates reaching 70 percent and losses of undeterminable values through theft.

In response to our report, Army established a special action group to oversee action on our recommendations. In addition, the Secretary of the Army sent a message to all commanders of major Army commands reiterating the importance of internal management controls and pointing out that these controls are an inherent part of every leader's job--of every commander's and manager's job--not something imposed from above.

Air Force

Hundreds of millions of dollars of Air Force resources were open to fraud, waste, and mismanagement, and we were unable to express an opinion on the Air Force's fiscal year 1988 financial statements, in part because of pervasive internal control problems similar to those identified for the Army. As we reported in our December 1992 transition series⁵ on financial management, the Air Force has made little or no progress in correcting the weaknesses pointed out by auditors. Only recently, in March 1993, did DOD and Air Force issue a comprehensive corrective action plan to deal with these weaknesses. We could not express an opinion on Air Force's

⁵See Transition Report entitled Financial Management Issues (GAO/OCG-93-4TR, December 1992).

financial statements because, among other things, the following conditions existed.

- Air Force organizations (1) neither reviewed and analyzed their general ledger records to ensure that they fairly reflected resources actually on hand nor reconciled those records with detailed supporting accounts and records, (2) made billions of dollars in erroneous entries and arbitrary adjustments to force agreement between related records, and (3) did not always record transactions in a timely manner.
- Air Force inventory systems did not accurately report either the quantities or values of high-dollar items actually on hand. Our physical counts of these items disclosed erroneous quantities on hand for many inventory items and over a billion dollars in errors.
- Air Force logistics centers (1) made billions of dollars in unsupported adjustments to their inventory records to force them into agreement with financial records in Air Force's general ledger and (2) did not investigate billions of dollars in differences between inventory and financial records.
- The Air Force paid more than \$630 million for communications satellites stored by contractors. These satellites were not on the Air Force's financial or property management records.

Navy

We are currently performing work which analyzes why the Navy had almost \$12.3 billion in unmatched disbursements as of February 1992. The unmatched disbursements are analogous to writing checks but not knowing what bills were paid. We are finding that the high level of unmatched disbursements was caused by internal control weaknesses in Navy's disbursement processes and a major accounting system. The weaknesses place Navy at risk of using funds contrary to congressional intent and/or making improper or fraudulent payments. In addition, the Naval Audit Service recently declined to express an opinion on the aircraft parts inventory portion of the Navy Stock Fund, which comprised 45 percent of the Fund's assets, because of accounting and recordkeeping deficiencies.

Defense Business Operations Fund

Our March 1, 1993, letter to the House and Senate defense committees--which we also provided to the Secretary of Defense--

discussed DOD's difficulties in implementing the \$81 billion Defense Business Operations Fund. These difficulties included serious deficiencies in control over the accuracy, reliability, and usefulness of information reported on the Fund's financial condition and operating results. Specifically, we noted for fiscal year 1992 (1) a gross difference of \$14 billion in amounts reported for operating results between the Fund's financial and budget reports, (2) a difference of \$9.4 billion between amounts cited for operating results by the Defense Finance and Accounting Service and the Air Force for its supply management business area, and (3) an average monthly unexplained difference of \$900 million between disbursements reported by the Fund and by the Treasury.

On April 20, 1993, The Secretary of Defense directed the Deputy Secretary and the Comptroller's organization to take the lead in reviewing the Fund, pointing out that ". . . if acceptable oversight of this system cannot be established, it is highly unlikely that either the Department of Defense or the Congress will continue with this system."

DOD'S ACCOUNTING SYSTEMS
DO NOT SUBSTANTIALLY COMPLY WITH
PRINCIPLES AND STANDARDS

DOD's detailed discussions of its accounting systems' nonconformity with the Comptroller General's principles and standards appear to contradict its overall assertion that its accounting systems substantially conform to the standards. Specifically, DOD stated that 225 of its 274 accounting systems substantially complied with these standards, and that all but 20 of the 187 material nonconformities identified and reported in DOD's accounting systems since FMFIA was implemented have been corrected. The data tend to hide the extent of DOD's accounting system shortcomings.

DOD's overall assertions are in sharp contrast with its detailed discussion of accounting systems problems. Specifically, in Enclosure D-1 to its FMFIA report, DOD states that it has material nonconformances in the following areas:

- general accounting system ledger control and financial reporting,
- property accounting,
- accounting for receivables,
- cost accounting,

- system controls,
- audit trails,
- system documentation,
- system operations,
- user information needs, and
- budgetary accounting.

Further, DOD reported similar major nonconformities with accounting principles and standards for the Defense Business Operations Fund, including problems with the military and civilian payroll procedures supporting the Fund. Clearly, these are all fundamental and serious weaknesses.

The annual FMFIA evaluation and reporting requirements should cause agencies to focus on how internal control and accounting system weaknesses affect managerial decisionmaking and accountability for resources provided and results achieved. In our view, DOD's implementation of FMFIA and its report do not reflect this emphasis. Rather, DOD appears to focus more on keeping score of the number of its material weaknesses and nonconformances than on the effect of the extremely serious problems that exist in its key accounting and financial management functions. These functions should be, but currently are not, offering a sound basis for managerial and budgetary decisions.

MANAGERIAL SELF-ASSESSMENTS HAVE NOT
IDENTIFIED SERIOUS INTERNAL CONTROL
WEAKNESSES

DOD's program of managerial self-assessments under FMFIA did not identify serious internal control weaknesses in the Department. For example, in January 1993 we reported⁶ that poor internal controls and inadequate systems at Army's maintenance depots did not protect weapons and equipment from deterioration and theft during shipment to depots and during the maintenance process. We noted that these weaknesses resulted in the waste of millions of dollars. Our report also pointed out that, even though these were long-standing problems, they had not been reported as

⁶Financial Management: Poor Internal Control Has Led to Increased Maintenance Costs and Deterioration of Equipment (GAO/AFMD-93-8, January 25, 1993).

material weaknesses in the Army's and DOD's FMFIA assurance statements. This report, as well as the reports on our financial audits at Air Force and Army,⁷ points out that DOD and the military services do not use the FMFIA process to provide for comprehensive and continuing assessments of internal control systems and candid disclosure of all material internal control weaknesses.

This information, along with our analysis of the material weaknesses disclosed in DOD's fiscal year 1992 report, clearly contradicts DOD's assertion that it has long operated systems of checks and balances and other internal control evaluations, as well as evaluations required by FMFIA, to ensure (1) prompt and full disclosure of control deficiencies, when identified, and (2) timely development and implementation of corrective actions. Rather, our December 1992 transition series report on financial management issues points out that past Air Force and Army FMFIA reports had not been fully candid in disclosing serious control and accounting problems. In addition, most of the material internal control weaknesses included in DOD's 1992 report were disclosed in audit reports. Of the 116 uncorrected material internal control weaknesses in DOD's 1992 FMFIA report, 92 were identified through audits, 9 were initially identified by audits and followed up on by FMFIA internal control reviews, and only 15 weaknesses were identified through FMFIA internal control reviews. Of the 50 corrected material internal control weaknesses, 40 were identified by audits, 3 were initially identified by audits but followed up on by FMFIA internal control reviews, and only 7 were identified by managerial assessments required under FMFIA.

While audit reports should be a key source to identify material internal control weaknesses, they should not be the chief source used by an agency. Audit coverage of an agency's operations, by its very nature, encompasses only a small portion of those operations during any fiscal year. Consequently, audit coverage should not be relied on to identify most of an agency's material internal control weaknesses. Because relatively few of DOD's

⁷Financial Audit: Air Force Does Not Effectively Account For Billions of Dollars of Resources (GAO/AFMD-90-23, January 23, 1991); and Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, August 3, 1992).

reported internal control weaknesses were self-identified, we believe that DOD's annual internal control evaluations have not achieved the intended benefits of the FMFIA process.

DOD'S ACTIONS TO DATE WILL
NOT CORRECT ALL WEAKNESSES

We believe that many of DOD's internal control and accounting system problems persist because DOD has not undertaken improvement initiatives that attack the root causes of those problems. For example, DOD's 1992 report stated that more than one-third of its corrective actions entailed revising or issuing new regulations and assigning responsibilities for carrying them out. However, many of the root causes, if not most, of the serious internal control weaknesses disclosed in our recent reports on DOD financial management were the failure of staff to actually carry out existing control procedures. For example, in our January 1993 report on Army maintenance depot operations, we pointed out that the depots we visited were not performing required physical inventories of weapons and equipment to validate information in inventory records. In fact, the report pointed out that, on average, the depots we visited completed only one-third of required physical inventories.

Our reports on our financial audits at Army and Air Force also pointed out the failures of staff to carry out existing control requirements as the root causes of major internal control weaknesses. Consequently, the promulgation of additional requirements for additional controls will not solve DOD's material internal control weaknesses.

With respect to the nonconformance of its accounting systems, DOD asserts that two major, long-term initiatives will solve these problems. These are (1) Defense Management Report initiatives, including the Corporate Information Management (CIM) initiative, which is to improve DOD business processes and information systems, and (2) the establishment of the Defense Business Operations Fund.

We agree that, as proposed in DOD's Corporate Information Management initiative, financial and related logistics systems need to be integrated to provide summary financial control over DOD's noncash, long-term resources. We also agree that the Defense Business Operations Fund, from a conceptual perspective, can reduce the cost of providing support to the military

services. However, as we have reported, these two initiatives currently have serious problems.

- The Corporate Information Management initiative to improve DOD's business processes and information systems has had limited success. It suffers from a lack of clear management direction, lines of authority, and responsibility for implementing it. In addition, it is focusing on selecting specific systems and technology without first determining what the goal of its business operations should be and how these operations should be improved. As a result, its goals of improved information systems and \$36 billion in savings through fiscal year 1997 may not be realized.
- Successful implementation of the Defense Business Operations Fund will require a substantial and continuing effort to (1) enhance DBOF financial management, (2) improve existing financial systems and develop new systems, (3) develop reliable baseline financial data, and (4) obtain needed management and personnel resources. As discussed earlier, DOD is not meeting its expectations for DBOF in these areas.

NEED FOR A STRONG FINANCIAL MANAGEMENT TEAM AT DOD

Recent budget cuts for defense occasioned by the end of the Cold War and the pressing need to reduce the structural budget deficit have highlighted the need to optimize the economy and efficiency of all DOD operations. This is necessary both to ensure that available budgetary resources are used to build the force structure needed to respond to threats and to keep the force at an optimal state of readiness. To achieve needed enhancements in economy and efficiency of operations, DOD needs to (1) make major improvements to its financial management operations and systems and (2) build a management team to make the system improvements work.

DOD has acted to improve its financial management operations and systems through major recent initiatives--Defense Management Report, Defense Business Operations Fund, and Corporate Information Management initiative, for example--but it needs to act on building the management team to bring these initiatives to full fruition. For example, our September 1992 report on CIM⁸

⁸Defense ADP: Corporate Information Management Must Overcome Major Problems (GAO/IMTEC-92-77, September 14, 1992).

cited the lack of effective management and funding control and DOD's failure to follow its information management improvement model as reasons for the program's limited progress and lack of success.

Unless the right top executive leadership is put in place and is fully supported by the most competent and experienced people from across the services and in the DOD financial and information management organizations, the Department will be unable to achieve a number of the cost savings anticipated by the Defense Management Report. In addition, DOD needs to devote, to the extent practicable, the needed budgetary resources to financial management improvement initiatives and to emphasize the training and development of people.

The CIM project is a case in point. It has been plagued by numerous leadership changes, organizational realignments, and at least three false starts. It has been over 3 years since CIM was initiated and DOD still has little to show for its efforts. Few business processes have been streamlined, few systems have been improved, and little progress has been made towards the \$36 billion in promised savings. CIM is taking much longer than expected; its potential for success is obviously waning.

DOD's financial management initiatives have merit and are consistent with "reinventing government." We believe that they deserve a chance to succeed. A strong management team is needed at DOD both to accomplish these initiatives and overcome the past neglect of systems and controls. With a strong management team, DOD can identify and correct control and systems weaknesses. Furthermore, and much more importantly, without such a team, progress in correcting these very serious weaknesses will definitely be limited.

CONCLUSIONS

DOD's internal financial and accounting control weaknesses currently pose the following risks:

- Waste, fraud, and abuse will occur and not be detected or will not be detected early enough to be dealt with effectively.
- Budgetary and force structure decisions will be based upon incorrect data.
- The success of critical DOD initiatives such as its Defense Business Operations Fund will be jeopardized.

-- Proposed improvements in DOD's operations or corrective actions for known deficiencies will not be effective.

These risks have the potential to severely embarrass the Department. They also could undermine public confidence at a time when the nation's taxpayers are being asked to bear a markedly heavier burden.

DOD's success in supporting the new administration's goals of increasing the federal government's efficiency and cost-effectiveness will to a large extent depend on the efforts you and your top officials make to identify and correct internal control and accounting system weaknesses through the FMFIA and other processes. This makes it even more important that you and the administration select knowledgeable individuals with proven financial management track records to fill key DOD leadership positions. Resolving DOD's long-standing financial management and control problems will be a daunting task, especially under an increasingly restrictive budgeting environment. That very environment, however, makes it increasingly important to be as efficient and cost-effective as possible if DOD is to maintain optimal force structure and readiness.

We expect to continue our audit and evaluation work of DOD's financial management operations, which is currently focused heavily on the Army. In addition, follow-up efforts related to our prior Air Force and Army financial statement audits will be a continuing priority, and we are preparing to begin an overall assessment of the Navy. We are continuing to monitor progress in implementing DBOF and CIM.

RELATED GAO PRODUCTS

Financial Management: Navy Industrial Fund Has Not Recovered Costs (GAO/AFMD-93-18, March 23, 1993).

Financial Management: Poor Internal Control Has Led to Increased Maintenance Costs and Deterioration of Equipment (GAO/AFMD-93-8, January 25, 1993).

Financial Management: DOD Faces Implementation Problems in Stock Funding Repairable Inventory Items (GAO/AFMD-92-15, December 26, 1991).

Air Force Depot Maintenance: Improved Pricing and Financial Management Practices Needed (GAO/AFMD-93-5, November 17, 1992).

Financial Management: Weak Financial Accounting Controls Leave Commodity Command Assets Vulnerable to Misuse (GAO/AFMD-92-61, September 4, 1992).

Financial Management: Army Conventional Ammunition Production Not Effectively Accounted for or Controlled (GAO/AFMD-92-57, August 31, 1992).

Financial Management: Internal Control Weaknesses Impede Air Force's Budgeting for Repairable Items (GAO/AFMD-92-47, August 26, 1992).

Financial Audit: Examination of Army's Financial Statements for Fiscal Year 1991 (GAO/AFMD-92-83, August 7, 1992).

Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, August 7, 1992).

Financial Management: Defense Business Operations Fund Implementation Status (GAO/T-AFMD-92-8, April 30, 1992).

Financial Audit: Aggressive Actions Needed for Air Force to Meet Objectives of the CFO Act (GAO/AFMD-92-12, February 19, 1992).

Financial Audit: Status of Air Force Actions to Correct Deficiencies in Financial Management Systems (GAO/AFMD-91-55, May 16, 1991).

Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, April 30, 1991).

Financial Audit: Financial Reporting and Internal Controls at the Air Logistics Centers (GAO/AFMD-91-34, April 5, 1991).

Financial Audit: Financial Reporting and Internal Controls at the Air Force Systems Command (GAO/AFMD-91-22, January 23, 1991).

Financial Audit: Air Force Does Not Effectively Account for Billions of Dollars of Resources (GAO/AFMD-90-23, February 23, 1990).

Air Force ADP: Lax Contract Oversight Led to Waste and Reduced Competition (GAO/IMTEC-93-3, November 19, 1992).

Defense ADP: Corporate Information Management Must Overcome Major Problems (GAO/IMTEC-92-77, September 14, 1992).

Air Force ADP: Status of Logistics Modernization Projects and CIM Impacts (GAO/IMTEC-92-66, July 30, 1992).

Embedded Computer Systems: Defense Does Not Know How Much It Spends on Software (GAO/IMTEC-92-62BR, July 6, 1992).

Defense ADP: Lessons Learned From Development of Defense Distribution System (GAO/IMTEC-92-25, March 20, 1992).

Defense ADP: Corporate Information Management Initiative Faces Significant Challenges (GAO/IMTEC-91-35, April 22, 1991).

Defense ADP: Corporate Information Management Savings Estimated Are Not Supported (GAO/IMTEC-91-18, February 22, 1991).

Air Force ADP: Logistics Systems Modernization Costs Continue to Increase (GAO/IMTEC-89-7FS, December 28, 1988).

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