Joint Statement

of

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Assistant Secretary of the Navy,
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and

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before the

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Mr. Chairman, Congressman Smith, members of the Committee: Thank you for the opportunity to report on the status of the Department of Defense's (DoD) financial management, with a specific focus on audit readiness. We are proud of what our enterprise-wide team has accomplished and are confident that we are on a solid path to financial auditability.

Because not everyone is a certified public accountant, we will preface our comments by explaining what a financial audit means. One sometimes hears in the media that the Pentagon is not being audited. On the contrary, we have hundreds of audits conducted on all facets of the Department's programs every year as part of what we consider very thorough government oversight. However, a financial statement audit is much different than a program audit. While audit principles are the same, program audits look at narrow slices of our business and are not time constrained. A financial audit, in contrast, is time sensitive and focuses on entire organizations and their processes. Contrary to popular belief, financial statement audits do not specifically look for potential waste or inefficiency. A clean opinion on a financial audit does not guarantee that all the funds were spent wisely. And the absence of a positive financial statement audit opinion does not mean that there is rampant waste or fraud, or that we do not know where we spend our money. The lack of an unmodified, or "clean," audit opinion does mean that our processes, systems and controls do not measure up to current accounting standards. We are working hard to make appropriate adjustments to fix this.

When Secretary Carter appeared before this committee on March 22, he described his reform agenda, which includes an emphasis on innovation in what we buy, how we attract and retain talent, how we think and operate and how we do business, from warfighting techniques to acquisition policy to our business processes, including achieving auditability. We assure you that Secretary Carter, Deputy Secretary Work, the Secretaries of our Military Departments, and other senior DoD leaders are committed to achieving and sustaining auditable financial statements to reassure Congress and the American public that DoD is a good steward of their funds.

Secretary Carter has clearly said that Congress and taxpayers should—and do—expect nothing less than auditable financial statements from DoD. We specifically appreciate your commitment to this issue. In that regard, the Committee's understanding of the issues related to this initiative and your leadership have been very instrumental. Congressman Conaway's 2012 panel, for example, directly contributed to our audit efforts, to include providing a comprehensive set of recommendations that we continue to implement and track. Our personal thanks go to him for his constructive support and engagement, and his Pentagon visits to attend meetings and monitor our efforts.

Six years ago, when the National Defense Authorization Act for Fiscal Year 2010 codified the requirement that our financial statements be audit ready by September 30, 2017, we were setting broad priorities, revising our strategy and methodology, and assessing business processes from end-to-end so that we could better understand the problem. In many ways, this "discovery" period has made us appreciate that the expertise, business processes, and systems that have served our national security mission so well were not developed with a financial audit in mind. Making the necessary changes in all three business elements—people, processes, and systems—takes time, but these changes are well underway and being evaluated by independent auditors.

Today, over 90 percent of the Department's $673 billion in current-year budgetary resources and 78 percent of total budgetary resources are under audit. Importantly, we know what work has to be done to prepare the remaining statements for audit. We have a credible plan in place and work is intensifying and finely focused. This is a great achievement and a testament to the sustained commitment of leadership at the highest levels and of the hard work of both financial and functional communities.

We would like to put this achievement as well as the magnitude of the challenge in better context for you. The Department of Defense operates around the globe, on land, on the seas, in the air, in space, and in cyberspace. We are arguably the largest organization in the world. We buy everything from basic supplies to satellites and ships; provide worldwide health services to our uniformed members, their families, and veterans; support research and development critical to our national security; deploy troops; house and move families; and operate schools, commissaries, and recreational facilities. We serve in peace keeping, humanitarian, and combat operations all over the world.

The sheer size and scope of our operations dwarf every federal agency and most multi-national companies. Each Military Department would make the Fortune 500 list in its own. In fiscal year (FY) 2015, the Department reported $560 billion in net costs, $2.3 trillion in assets, and $2.4 trillion in liabilities. We manage nearly 3 million active duty, reserve, and civilian personnel and provide benefits to more than 2 million military retirees and their family members.

While the Department's size has varied through history, we are quite large and it will take many years to fully integrate our processes and systems so that they can successfully sustain an audit. Change is always hard, but changing a huge, global enterprise in a resource constrained, dynamic national security environment has been a truly daunting task.

Progress to Date

Last fiscal year, each Military Department began its first independent audit of its General Fund FY 2015 appropriations, and most of the larger defense organizations completed mock audits of their FY 2015 budgetary resources. (A mock audit is different from an audit or examination in that we are using experienced auditors to conduct "audit-like" reviews or testing, but these auditors support management and, as a result, are not considered independent." For smaller organizations, this is a more reasonable use of resources.) Additionally, a number of reporting entities are sustaining positive audit opinions on their full financial statements, including the U.S. Army Corps of Engineers – Civil Works; the Defense Finance and Accounting Service; the Defense Contract Audit Agency; the Defense Commissary Agency; and two of our largest funds, the Medicare-Eligible Retiree Health Care Fund and the Military Retirement Fund. The Defense Information Systems Agency and the Defense Logistics Agency recently contracted for a full financial statement audit. Next year, full financial statement audits are expected to begin for the U.S. Special Operations Command, the U.S. Transportation Command, and the Defense Health Programs.

We currently grade and rank all organizations relative to how advanced they are in achieving auditable financial statements. This also ensures that senior leaders can monitor progress in those areas most critical to audit readiness, such as having a complete list of assets or balancing our “checkbook” with the Department of the Treasury. We continue to closely monitor progress against the critical capabilities. Our May 2016 Financial Improvement and Audit Readiness Plan Status Report details the status and plans of the Military Departments and other Defense entities. The Assistant Secretaries for Financial Management and Comptroller for each Military Department are fully engaged and each of us provides a brief summary of the status of audit efforts within our military department. While individual Service plans may vary based on unique aspects and conditions of each Service, their approaches are sound and their commitment is constant and unified.

Army Perspective on Progress to Date

Audit readiness is a top priority for the Department of the Army. Army leaders remain fully committed and actively engaged in ensuring compliance with auditability and sustainability requirements, while working to improve Army financial management.

The Army has been using a series of successive audits of its General Fund Schedule of Budgetary Activity (SBA) and targeted elements of the balance sheets in order to drive towards meeting Congress' requirement and senior leaders' desire for asserting auditable financial statements by September 30, 2017. In addition to SBA audit activities, the Army is establishing methodologies for valuing balance sheet assets and liabilities, including real property (buildings), general equipment (end-user equipment, such as helicopters), operating material and supplies (e.g., ammunition), and environmental liabilities (e.g., environmental cleanup and disposal costs). The Army plans include continued use of audits and examinations to drive financial improvements that will lead to fiscal responsibility and supportable financial statements. The Army's FY 2016 General Fund SBA audit is now underway. In addition, the Army has expanded efforts into a limited-scope audit of the Army's working capital fund.

Throughout and following these audits, the Army uses audit results to develop corrective action plans to focus efforts and resources on remediating deficiencies. Army leaders monitor efforts and status of the organizations responsible for remediating and achieving the identified corrective actions. These corrective actions will be the critical factor in the Army's ability to meet the congressionally-mandated deadline. In addition, these audits are building experience and understanding across the Army as to what financial statement audits require and what will be required to sustain audit readiness. The Army is fully committed to asserting full financial statement audit readiness by September 30, 2017.

Navy Perspective on Progress to Date

During the FY 2015 SBA audit, Navy commands produced on time over ninety-five percent of the documentation requested by the auditors. Careful preparation, solid teamwork, and tremendous dedication to task were clearly demonstrated. Post-audit, Navy has implemented an aggressive enterprise-wide approach to correct deficiencies. A flag officer or senior executive is accountable for the correction of each audit finding under his or her purview. Progress is closely monitored and sustainable swift results are required.

The Navy and Marine Corps teams are executing comprehensive game plans to achieve audit readiness on all four financial statements by FY 2017. These plans emphasize sustainable, standardized, efficient business processes, improved controls over business processes, and consolidation of information technology (IT) systems. The Department is implementing the Department of Treasury's "G-Invoicing" program which will standardize processes, receipt, and acceptance for reimbursable work orders. Navy is replacing one of its two General Fund accounting systems with the Marine Corps' general ledger, which is more audit-compliant. Navy continues to implement changes to Navy Enterprise Resource Planning to expand its capabilities and audit compliance.

In addition, Navy commands are now tracking, documenting, and reducing the number of accounting adjustments while eliminating the root causes for the adjustments. The Navy is also instituting regular reconciliations, facilitating end-to-end tracking of all financial transaction data flowing between systems. Finally, the Service has made major strides in accountability for major military assets, especially in the areas of real estate, inventory, ordnance, and military equipment.

The U.S. Marine Corps (USMC) has made major improvements in its business environment in the years since it became the first Service to undergo audit. The progress the Marines have made in audit readiness is directly attributable to the leadership and diligence its team has shown. It is presently on track to assert auditability on all four of the USMC statements at the end of FY 2016, a year earlier than the Congressional mandate requires. The Marine Corps' experiences with "full" financial statement audits will be a tremendous help to the Navy and the other Services in preparing for audits.

Air Force Perspective on Progress to Date

The Air Force continues to make significant progress in its drive to produce auditable financial statements by September 30, 2017. Air Force commitments to accountability and continued responsible financial management are evidenced by the results produced by its airmen and service providers. As mentioned in the "Progress to Date" section of this statement, the Air Force completed its first ever audit of the General Fund Schedule of Budgetary Activity for FY 2015. This marked a critical milestone for Air Force audit readiness efforts, validated its strategy, and provided valuable insight and areas for improvement in Air Force business operations. The Air Force has worked closely with its auditors to prioritize findings and recommendations from the audit and implement cost-effective corrective actions.

The active engagement of Air Force leaders has been critical to its success, and the Air Force continues to include financial improvement and auditability goals in the annual performance plans for all of its senior executives. Significant progress has been made in recent years, but there is a long way to go. Our new financial management system, the Defense Enterprise Accounting and Management System (DEAMS) will serve as the foundation for long-term Air Force financial management improvement efforts. DEAMS has deployed to approximately half of the entire Air Force user base and provides inherent accounting controls in a commercial off-the-shelf accounting system. As the Air Force transitions from legacy systems to an enterprise solution, it continues to embed audit improvements in it business processes.

While the history of other federal agencies' financial audits shows that large agencies take three to five years to achieve unmodified audit opinions, the Air Force is committed to becoming audit ready and to ultimately achieve an unmodified audit opinion as soon as possible. The magnitude, complexity, and nature of Air Force operations, processes, and systems create challenges, but it continues to make progress. The Air Force knows what work needs to be done, and it has a credible plan in place to accomplish it.

Interpreting Initial Audit Results

The individual audits of the Military Departments' General Fund FY 2015 appropriations each resulted in a disclaimer. In other words, sufficient information was not readily available for auditors to make judgments, so auditors could not complete the audits. These outcomes were fully expected. Audits of the Military Departments' FY 2016 Schedules of Budgetary Activity are underway and similar results are expected. While the opinions, themselves, may not change, we are committed to demonstrating progress by prioritizing and fixing documented problems.

Because the approach of building an initial foundation with audits of current year budgetary resources began with the Marine Corps, we recognize the Corps' role in "taking the beach" for us in what has been an enduring annual campaign, from which we have learned many lessons. In its third year of effort, it received an unmodified (or clean) opinion from the DoD Office of Inspector General (DoD OIG) on its FY 2012 SBA. This opinion was later withdrawn after a subsequent audit identified uncertainty involved in handling suspense accounts. While a recent review determined the value of these suspense accounts to be less than material, the DoD OIG stated that it was no longer cost effective to try to support a restatement of the earlier clean opinion, particularly as the Government Accountability Office had highlighted additional concerns with this opinion. All parties agree, however, that the Marine Corps has made significant progress with these limited scope audits and will enter a full financial statement audit next year. This is an example of where setbacks on this audit journey can actually support later progress.

One lesson that we have learned is that it takes time for the audit infrastructure to mature, lessons learned to be implemented, and findings remediated. For example, it took the Department of Homeland Security ten years to achieve an unmodified opinion on its full financial statements, and its budgetary resources are only $89 billion compared to DoD's approximately $1 trillion in budgetary resources—one-tenth the size of DoD's. Again, the resulting disclaimers were not unexpected. It will still take many years before a positive audit opinion is received. We have a lot of work to do to improve our overall business practices and systems, both to improve the quality of our financial information across the enterprise and to pass an independent audit.

Addressing Audit Findings

So what is left to do to get to the 2017 goal? Our first priority is to fix known problems and address auditor findings. The initial, limited-scope audits of the Military Departments resulted in more than 400 combined auditor findings and recommendations. The large number of problems and the redundancy of problems across the components suggest systemic issues. Solving these problems requires the concerted efforts of many, not just the military Services' and not just the financial management community's. What is a problem for one organization may very well be a problem for another organization. Policies must be updated and new procedures put in place. Leaders have made resolving these issues a priority, and acquisition personnel, logisticians, and resource managers all have a role to play.

Findings from the initial audits primarily fall into the broad categories of:

- Documentation,
- IT systems,
- Balancing our "checkbook" with the Department of Treasury, and
- Manual corrections.

<u>Documentation</u>

Documentation is one of our biggest hurdles. Auditors found we are too often missing either the documentation to support the transaction, itself, or the documentation to support the authority for the transaction. For example, an auditor test of civilian pay could examine a sampling of new hire paperwork, timesheets, leave requests, annual performance reviews, and promotions. Each piece of documentation would be checked for proper signatures and approvals, timeliness, and so on. Auditors would want to confirm that policies and procedures are being followed and records maintained, not just whether the proper amount was paid. For FY 2015, the civilian pay processed by the Defense Finance and Accounting Service (DFAS) was approximately $50 billion and is just one example of an area auditors could explore. Each day we complete hundreds of thousands of transactions—from purchasing lightbulbs to deploying troops worldwide. In FY 2015, DFAS processed 135.7 million pay transactions, made 5.7 million travel payments, and paid 11.8 million commercial invoices. For each transaction, proper documentation must exist and be available to auditors. Documentation is equally important in providing both the authority or, in some cases, the methodology for the business process. Remediation actions are focusing on using electronic media and developing central repositories for key documentation, supporting more timely access.

IT Controls

Auditors found that IT controls, such as security measures, were not effective or not in place. For example, in some instances auditors found that people who had left their positions within an organization still had access to its systems. In addition to financial audit implications, IT controls also support our cybersecurity goals and are particularly critical because of the sheer size of our enterprise. Remediation actions are focusing on integrating current systems' accreditation processes under CIO cognizance with additional reviews that directly support financial controls and the audit.

Balancing our "Checkbook" with the Department of the Treasury

Each month, our records get reconciled to records held by the Department of the Treasury. The process is similar to a personal checking account balance that must be increased for deposits (appropriations and collections), decreased for expenditures, and then balanced to a bank statement. Due to the size of the DoD budget, the multitude of systems, and the enormous amount of funds expended and collected, the number of accounting transactions that must be reconciled between DoD accounts and Treasury is very large and the task complex. Auditors found that often the entity did not have a process to routinely balance its checkbook and resolve any discrepancies. Remediation actions have been directed at addressing root causes for current transaction exceptions, as well as implementing automated tools that support regular cash reconciliations.

Manual Corrections

When problems arise with balancing our books, we too often make a manual correction, more commonly referred to as a journal voucher, to record the adjustment. One audit cited 20,000 journal vouchers in one month. Manual corrections often lack supporting documentation to justify the adjustment. Additionally, too many manual corrections may be an indicator of underlying problems, such as weak internal controls. For an auditor, manual corrections are a red-flag for transactions not being captured, reported, or summarized correctly. Auditors must judge whether the errors that triggered the correction are isolated or systemic, leading them to select more transactions to test. If the auditors cannot estimate the magnitude of the errors, they may not be able to complete the audit or issue an opinion on the financial statements. Remediation actions for this category vary, but the largest material weakness (dollar wise) involves reconciling intragovernmental business transactions. DoD is working closely with Treasury to develop and implement a much needed, government-wide solution.

Remaining Challenges

While significant progress has been made on our current priorities related to budgetary execution and asset accountability, much more work remains. This work can be addressed in terms of three specific high-risk categories: valuing assets, preparing information related to sensitive activities, and IT systems.

Valuing Assets

Fixing these known problems is our top priority. Our biggest challenge, however, is having a complete list and cost of our assets. The Department manages a huge inventory of assets, consisting of more than 500,000 buildings and other structures located at nearly 5,000 different sites. Our Real Property totals more than $1 trillion in replacement value. Assets also include inventories of supplies, military equipment, and software. Inventory and Operating Materials and Supplies total over $250 billion (gross) and Equipment, when measured in historical cost, totals over $1 trillion.

In order to complete an audit, we have to know with certainty that all of our assets have been inventoried and how much we paid for them. This is especially hard with historical assets, many of which were acquired long ago. Sometimes the original documentation just does not exist. We have been working with the outside board that sets federal accounting standards to develop practical, cost-effective alternatives for how we establish the value of an asset at the time it was acquired. The Federal Accounting Standards Advisory Board is even allowing us to forgo the valuation of existing land and software as a one-time exception to the rule. For other assets, we must still assign a value, and going forward, we must have the processes in place to manage all assets correctly.

Preparing Information Related to Sensitive Activities

Additionally, all of the financial information we are preparing for audit in other areas must be reported and audited for sensitive and classified activities. Auditors with appropriate clearance are being brought in, but providing sensitive documentation and accessing classified systems is taking extra time. We realize that this information must be included in our audits, but both audit and financial reporting processes must be in place to properly protect it.

IT Systems

It should come as no surprise to the Committee that IT systems also continue to be a challenge. The Department's IT systems environment includes a mix of legacy and modern systems. There are over 1,000 systems and nearly 400 separate IT systems directly relevant to audit. Most of the business legacy systems were designed to support a particular function, such as property management. As a result, a single transaction may pass through several different systems as it moves through different functional areas. In addition to being inefficient, multiple entries dramatically increase the likelihood of human error. Further, auditors cannot trace our dollars when transactions move from one system to another. Because the systems were not integrated when they were set up, fixing problems requires a lot of manual workarounds, stretching resources even more thinly. Outdated policies and procedures have triggered unnecessary system modifications that exacerbate the problem, and many of the legacy systems will still be in use when we begin full financial statement audits in FY 2018. Implementing integrated systems, along with making policy and procedure changes, is being consistently supported by management.

Projections for FY 2017 and Beyond

Documentation, valuing assets, IT systems and controls, sensitive information—these are the areas we are watching most closely. Our plan for addressing problems and going under audit is sound, and initial audits underscore both our progress and our plan for moving forward. We currently have a plan to present the entire Department of Defense for audit. It will involve individual standalone audits for the following organizational entities:

- Military Departments,
- Largest (most "material") Defense Agencies and funds,
- Components and funds that already have financial statement audit opinions, and
- Defense intelligence agencies.

These audits are essential and cover, on a standalone basis, the vast majority of the information that makes up the DoD Consolidated Financial Statements. More importantly, these audits should satisfy both Congress' and the American people's desire for improved visibility and assurance that we are being good stewards of the funds entrusted to us. Stewardship also includes not spending funds unnecessarily. The cost both in time and resources of contracting for and beginning an audit of our consolidated financial statements, when impediments to success are known to exist, are prohibitive. We must continue to mitigate and evaluate risks related to a full audit before proceeding to the audit, itself.

Over the next 16 months and beyond, we will continue to improve systems, simplify procedures, and transition our workforce into the new way of doing business—annual audits. Working groups are addressing the most challenging policy issues, legacy systems are being sunset, and better systems deployed. Leaders are maintaining momentum by embracing better and more efficient ways of doing business.

In March 2016, each Military Department's reported to the Deputy Secretary of Defense and the Vice Chairman of the Joint Chiefs of Staff that it would be audit ready by September 30, 2017, and were committed to entering a full financial statement audit in FY 2018. Given the significant work remaining, the Deputy Secretary asked for another reassessment this fall. He stressed the importance of making and sustaining improvements, and leaders are aware there is a long way to go before the Department achieves the same level of excellence in its business operations as it has in its mission operations. Senior leaders will continue to review the Department's audit readiness status to ensure audit remains a visible Department-wide priority and progress remains on track.

This kind of high-level visibility and commitment is essential as we prepare to transition to a new administration. We are transforming long-standing business processes that have supported our missions for many years but that were not always sufficient. We have also established sufficient positive momentum for this important initiative that will assure that it will readily transition to the next leadership team.

Current Incentives Are Sufficient and Stability is Important

As mentioned before, we greatly appreciate the support the Committee has given the Department in moving us to audit. The attention you focus in your oversight role is positive, constructive, and needed. However, there are currently some members of Congress who question our commitment to and progress on audit. They want to add disincentives that would be counterproductive to the teamwork and the synergy we have built across the defense enterprise. For example, the Administration objects to language in section 901 of S.2943, the Senate Armed Services Committee National Defense Authorization Act for Fiscal Year 2017, which would move DFAS from the Under Secretary of Defense (Comptroller) to the Under Secretary of Defense (Business Management and Support) organization. DFAS performs important financial management and pay functions that are and should remain under the purview of the Chief Financial Officer (CFO). This action would remove core financial management functions, including payment of the Department's vendors, cash management, and financial audit support from the supervision of the CFO and sever critical links between DFAS and the CFO with respect to management of the Department's funding and audit functions. A crucial ingredient to all the Services achieving unqualified financial audit opinions is the role DFAS plays as a service provider. As the DOD focal point for audit, the CFO's centralized control of the service provider and the audit plan ensures all are vectored properly. Moving DFAS away from the Comptroller community or even out of the Department is divisive and harmful to the forward motion we are experiencing right now. Moving DFAS introduces unnecessary churn, complexities, and risks to our efforts to improve financial processes and achieve auditability. This would create extensive layers of bureaucracy, further obfuscating an already complex environment, and raising issues of jurisdiction and organizational boundaries, compliance with policy, and unclear lines of authority. As a service provider, DFAS is only a part of the total end-to-end processes to produce auditable financial statements. The transfer would not solve any operational accounting issues and would only create a delay in achieving auditability. We hope you consider and share with colleagues that these kinds of disincentives undermine the strength of the audit teamwork already built. We are sure that is not what Congress wants.

Conclusion

Mr. Chairman, this completes a brief review of just some of our many efforts to continue to improve Defense financial management, in order to become auditable. While we have made significant progress, challenges remain and there is much work still to do. We close by reiterating DoD's strong commitment to improved financial management, including auditability. We owe it to you. We owe it to the troops. And we owe it to the American people.