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House Armed Services Committee

Testimony

Before the
House Armed Services Committee

Department of Defense Update on the
Financial Improvement and Audit Remediation (FIAR) Plan

By
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January 10, 2018

Introduction

Chairman Thornberry, Ranking Member Smith, and members of the Committee, thank you for the opportunity to provide an overview of the Department's financial statement audit progress and plans. I appreciate your Committee's long and unwavering support for this effort. I also want to thank Congressman Conaway for his leadership over the years related to this audit. His direction of the Committee's 2011 panel on Financial Management and Auditability helped the Department maintain its focus on audit.

When the President made a promise to the American people to rebuild the U.S. Armed Forces, he also made a commitment to start the audit. Inside DoD, Secretary Mattis and Deputy Secretary Shanahan have set the tone from the top that embraces the audit as part of their vision to bring business reform to the Department of Defense.

I know you have had many hearings where witnesses have told you that they support the start of an audit eventually. This hearing is different. **We have started the audit.** But we are only able to have today's hearing with DoD under its first full financial statement audit because of this Committee's continued support.

Audits are not new to the Department of Defense. Numerous audits covering program performance and contract costs are completed each year by the Government Accountability Office (GAO), the Defense Contract Audit Agency (DCAA), the Department of Defense Office of the Inspector General (DoD OIG), and the services' audit agencies. For example, the DCAA employs over 4,000 auditors to perform contract audits that are focused on identifying inappropriate charges by contractors to the Government. However, this is the first time that the Department is undergoing a full financial statement audit. **A financial statement audit is comprehensive. It occurs annually and it covers more than financial management.** For example, financial statement audits include:

- Verifying count, location and condition of our military equipment, real property and inventory
- Testing security vulnerabilities in our business systems
- Validating accuracy of personnel records and actions such as promotions and separations

The DoD anticipates having approximately **1,200 financial statement auditors** assessing whether our books and records present a true and accurate picture of our financial condition and results of our operations in accordance with accounting standards. These financial statement audits complement but are distinct from audits of program performance or contract costs.

Based on my experience at the Department of Homeland Security, it will take time to implement all the process and system changes necessary to pass the audit. It took the Department of Homeland Security, a relatively new and much smaller enterprise, about ten years to get to its first clean opinion. But **we don't have to wait for a clean opinion to see the benefits of the audit**. The financial statement audit helps drive enterprise-wide improvements to standardize our business processes and improve the quality of our data.

Why DoD Must Be Audited and What That Means

Just like private sector companies and other federal agencies, the DoD prepares financial statements every year to report its assets, liabilities, revenues, and expenses. Though not a corporation, **DoD owes accountability to the American people**. The taxpayers deserve the same level of confidence as a shareholder that DoD's financial statements present a true and accurate picture of its financial condition and operations. Transparency, accountability and business process reform are some of the benefits from the financial statement audit:

- 1) Transparency: the audit improves the quality of our financial statements and underlying data available to the public, including a reliable picture of our assets, liabilities and spending. DoD's progress towards a positive audit opinion will also

directly contribute to an audit opinion on the entire federal government's assets and liabilities.

- 2) **Accountability:** the audit will highlight areas where we need to improve our accountability over assets and resources. For example, during an initial audit, the Army found 39 Blackhawk helicopters that had not been recorded in the property system. Also, the Air Force identified 478 buildings and structures at twelve installations that were not in its real property system. By fixing the property records, we can demonstrate full accountability of our assets. In other cases, as the Department invests in new business systems, we will be able to obtain independent auditor feedback on the system's compliance so we can better hold vendors accountable for their solutions.
- 3) **Business Process Reform:** the combination of better data, business processes reengineering and the use of modern data analytics directly supports Congress' vision of the Chief Management Officer position and DoD's efforts to bring business reform to its operations. These reforms will lead to business operations savings that can be reinvested in lethality.

The cost of performing the audit will be \$367 million in FY 2018. This amount covers the audit fees to the Independent Public Accounting (IPA) firms (\$181 million) and infrastructure to support the audits (\$186 million). The \$181 million in audit contract costs is approximately 1/30th of 1% of DoD's budget and, as a percentage of revenue, is equal to or less than what Fortune 100 companies such as General Electric, Proctor & Gamble and International Business Machines Corporation (IBM) pay their auditors. In addition, we anticipate spending about \$551 million in FY 2018 fixing problems identified by the auditors.

How We Got Here?

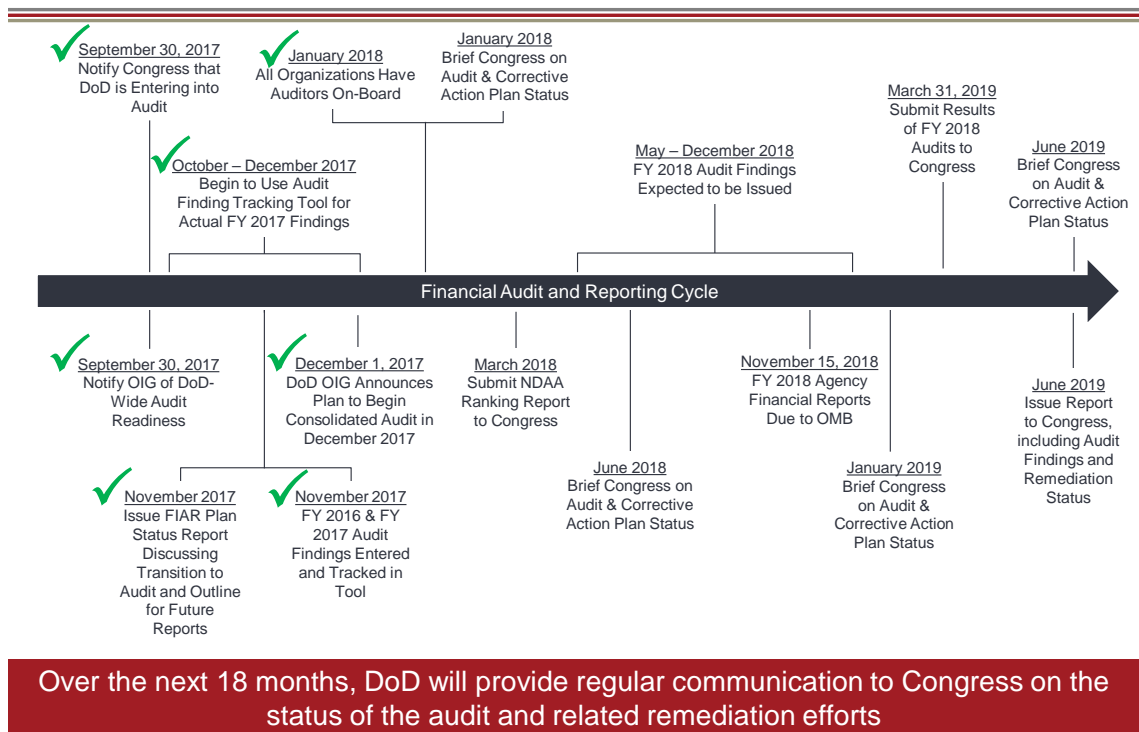
The financial statement audit requirement was initially established in 1990 when Congress passed the Chief Financial Officer Act, which, as amended, required the 24 largest federal agencies to complete independent annual financial statement audits. As you are aware, until this year DoD was the only large federal agency not under full financial statement audit. The size and complexity of our enterprise, combined with the pace of our military operations, made meeting this requirement challenging.

In a move that helped keep the Department on course, the National Defense Authorization Act for FY 2014 mandated that DoD conduct an audit in Fiscal Year 2018. Consistent with this requirement, we provided notification to Congress, in September 2017, that the Department was starting a full financial statement audit for FY 2018. Consequently, the DoD OIG announced the start of the FY 2018 financial statement audit in December 2017.

How the Audit Will be Conducted

The DoD consolidated audit will likely be one of the largest audits ever undertaken and comprises more than 24 stand-alone audits and an overarching consolidated audit. DoD is currently sustaining clean opinions for nine stand-alone audits. Audits will be conducted by the IPA firms with the DoD OIG performing the consolidated audit. All audit contracts have been awarded and auditors have begun to arrive.

Fiscal Year 2018 Timeline



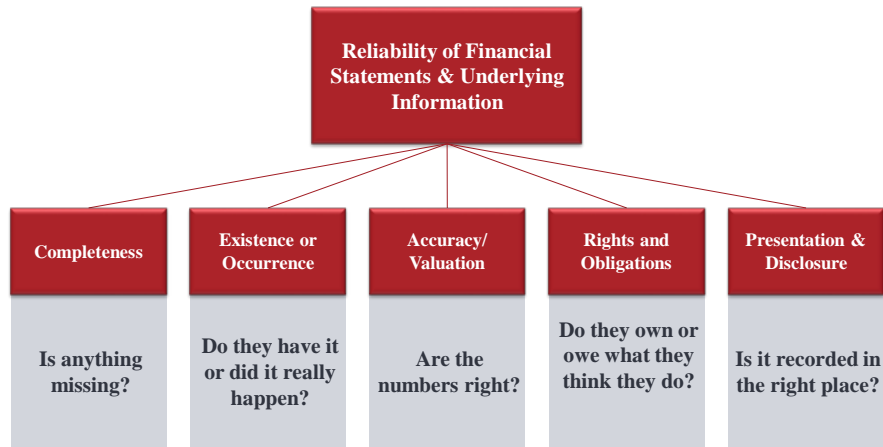
During an audit, the auditors will select line items on the financial statements based on materiality and risk, such as Property, and they will ask for a listing of items or transactions that make up the total amount on the financial statements. For example, for Property, the listing should have all the buildings, equipment, and software that equal the total amount of property.

The auditors will then pick samples from the listing for testing. Testing will include physically verifying that the property exists and is accurately recorded in the property system.

Once the auditors have completed testing, they will evaluate the results to determine if the financial statements are presented fairly in all material respects in accordance with accounting standards. The auditors will report any problems they find at the end of the audit cycle and will reevaluate the status of corrective actions annually.

The pictorial below depicts the focus areas for financial statement auditors.

What Is a Financial Statement Auditor Looking for?

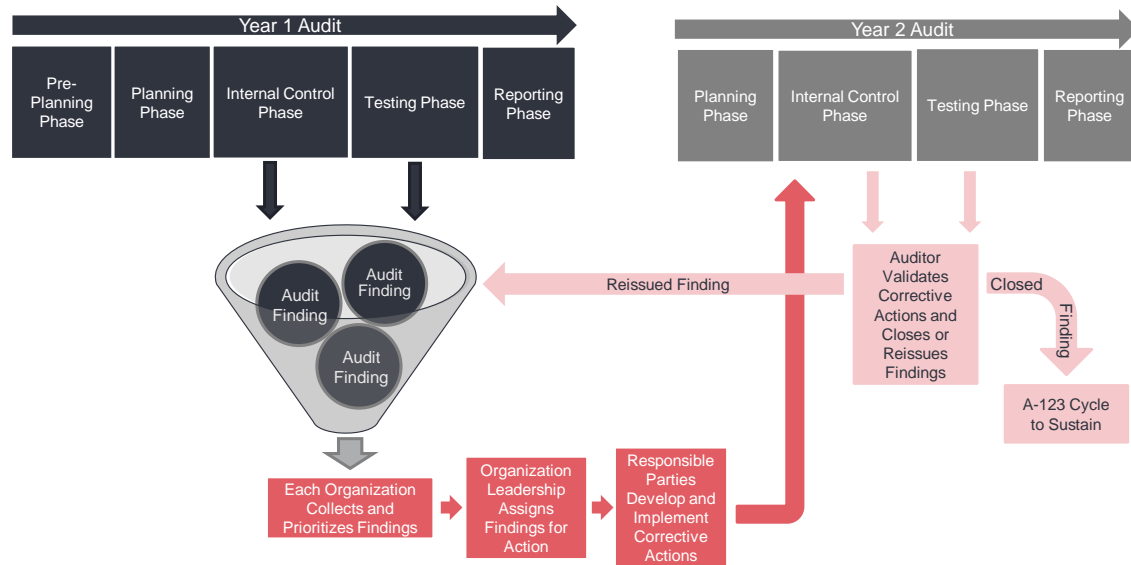


Measuring Progress

For years, the Department received a disclaimer of opinion on the DoD-wide financial statements from the DoD OIG. This means the Department could not adequately support the accuracy of our financial information or fully account for our assets, spare parts and other inventory items. These disclaimers were based on management’s assertions, and not based on independent audit testing. Beginning this year, audit opinions will be based on comprehensive auditor testing and will result in actionable feedback.

In order to track progress, the Department has established a tool and a process to capture, prioritize, assign responsibility for, and develop corrective actions to address audit findings. Each year, the auditors will assess and report on whether the Department has successfully addressed the findings. **Going forward, we will measure and report progress toward achieving a positive audit opinion using the number of audit findings resolved.**

Annual Financial Statement Audit Feedback Cycle



Closing

In closing, I want to thank this Committee for its continuous focus on the importance of a DoD audit. Your oversight through the years has been a catalyst, and we appreciate the partnership we enjoy with you and with the Committee staff on this important process. With your oversight and under this Administration's leadership we are now and will continue to be a department that is not only under audit, but also improving, year after year.

As we move forward, your continued support for budget stability, information technology and funding to remediate audit findings remains critical in moving the Department towards achieving a positive opinion.

I look forward to providing you with an update as we progress with our first full financial statement audit. I'll be ready to discuss what we've learned and where our focus will be in the second year of our annual audit cycle.

I look forward to your questions.