

**House Armed Services Committee
Written Statement for the Record
The Honorable David L. Norquist
Performing the Duties of the Deputy Secretary of Defense
16 May 2019**

Chairman Smith, Ranking Member Thornberry, distinguished members of the Committee, I appreciate the opportunity to testify before you today on the financial statement audit, a key priority for the Department of Defense.

I'm joined by the Service Financial Managers—the Honorable John Whitley, Assistant Secretary of the Army (Financial Management and Comptroller); the Honorable Thomas Harker, CPA, Assistant Secretary of the Navy (Financial Management and Comptroller); and the Honorable John Roth, Assistant Secretary of the Air Force (Financial Management and Comptroller)—all of whom are prepared to answer your questions on their respective service audits.

I'd like to start by thanking you for your commitment to National Security, your unwavering support for the Department of Defense and, in particular, your support for and interest in the audit.

Why a financial statement audit?

The financial statement audit requirement was initially established in 1990 when Congress passed the Chief Financial Officers Act, which, as amended, required the 24 largest federal agencies to complete independent annual financial statement audits. Until last year, DoD was the only large federal agency not under full financial statement audit.

Together, we have changed that. On November 15, 2018 the Department of Defense completed its first ever department-wide financial statement audit, fulfilling a presidential commitment and beginning to address this longstanding congressional concern.

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 underwent a full financial statement audit. Financial statements summarize the Department's assets and liabilities—everything the Department owns and owes—and the Department's program costs, revenue, and budgetary resources. 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;
- And validating accuracy of personnel records and actions such as promotions and separations.

What did the auditors do?

The audit was extensive. Given the Department's size—\$2.7 trillion in assets and \$2.6 trillion in liabilities—conducting the audit required an historic effort that amounted to the largest financial statement audit ever. It involved approximately 1,200 auditors reviewing hundreds of thousands of items; more than 24 stand-alone audits, plus an overarching consolidated audit; over 900 site visits to 600 different locations; and the tireless efforts of many within the Department.

To do this work, the auditors went through billions of transactions, pulled statistically valid samples, and then tested them for accuracy and completeness. For example, for each payment to a contractor, do we have an invoice, a receiving report, and a contract that match? Likewise, for each payment to an employee, military or civilian, do we have proof that it was the correct payment for that employee? The auditors also went through our databases of property, of inventory, of equipment, pulled statistically valid samples, and tested them, verifying the count, location, and condition of that equipment.

For example, with respect to real property, the auditors asked the Navy for their database of real property—to include buildings, underground water pipes, fence lines, etc.—and pulled a statistical sample from that report. They then went to a select number of bases with that list and checked everything that is supposed to be on each base—whether it was there and what condition it was in to determine whether you had the records to demonstrate that you owned it and that information was consistent and accurate. The auditors also looked around the base for any other property and checked to see if it was recorded. They did the same thing with inventory, going to warehouses, pulling samples of spare parts, and looking for completeness.

The cost of performing the audit was \$413 million in FY 2018. This amount covers the audit fees to the Independent Public Accounting (IPA) firms (\$182 million) and infrastructure to support the audits (\$231 million). The \$182 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 (IBM) pay their auditors. In addition, we anticipate spending about \$559 million in FY 2018 fixing problems identified by the auditors.

What were the audit results?

To summarize:

- Six organizations received unmodified (clean) audit opinions, which is the highest rating: U.S. Army Corps of Engineers (USACE) Civil Works, Military Retirement Fund (MRF), DoD Office of Inspector General (DoD OIG), Defense Health Agency – Contract Resource Management (DHA – CRM), Defense Finance and Accounting Service – Working Capital Fund (DFAS), and the Defense Contract Audit Agency (DCAA).
- Two, the Defense Commissary Agency and the Medicare-Eligible Retiree Health Care Fund, received modified opinions, which means the data is right with some modest exceptions.

- The remaining organizations received a disclaimer, which means the auditors did not have enough evidence to provide an opinion.

No organization received an adverse opinion, the lowest level; and the auditors found no evidence of fraud and provided favorable feedback that the Army, Navy, and Air Force had properly accounted for major military equipment and military and civilian pay.

The auditors identified over 2,300 findings, which they call Notifications of Findings and Recommendations (NFRs). The findings were detailed and compelling. For example, the auditors pulled a sample of real property assets for the Navy and found that about 6.5 percent of them no longer existed, and the Army, who had very few errors on existence, had a number of facilities erroneously listed as being in usable condition. The auditors found similar issues with inventory: either items noted to be in a specific warehouse had already been moved to another location or been used, assets sitting in warehouses were not in the inventory system, and that assets recorded to be in good condition were unserviceable. At Hill Air Force Base, for example, the auditors pulled a sample of uninstalled missile motors and found that seventy-one of them, worth \$53M, were incorrectly recorded as unserviceable.

Identifying these problems is not a step backwards. They are a step forwards. The very purpose of the audit was to find as many problems as we could so we could start to fix them. In fact, while most audits stop as soon as the auditors have determined the organization won't get a clean opinion, we worked with the Inspector General to arrange for the auditors to keep going in order to find as many problems as possible.

One of the other benefits of the audit is that we have addressed two fundamental misconceptions about the financial statement audit itself. The first is the belief that it's a paperwork exercise that is irrelevant because we're not a company selling stock. The accuracy and completeness of our real estate, inventory, budget information, and equipment records matters to the mission—and that became very clear to people as soon as the audit was underway. The second misconception is that the audit would find a pot of gold, which generally results from an all too easy misunderstanding of the difference between budgeting and accounting.

What are we doing now?

For the over 2,300 Notifications of Findings and Recommendations (NFRs) the auditors found and entered into our database, the Department has developed Corrective Action Plans (CAPs) to address 91.5% of them as of May 13, 2019. Some of these Corrective Action Plans will take months to execute, while other will take years—and in July, the auditors will begin to test the problems we think we've fixed.

This database is already proving enormously valuable—allowing us to track our progress resolving these issues—taking us from a simple “did we pass the audit” level of analysis to a detailed understanding of whether, and in what areas, we are improving. For the first time, the Department has real, granular insight into itself, as well as real tools for oversight and accountability.

Within the thousands of identified issues, Acting Secretary Shanahan has directed the Department to “prioritize corrective actions that provide the greatest value to our operations and our warfighters, starting with”: real property; inventory and operating material and supplies; and information technology (IT).

By the end of the year, he directed each accountable organization to conduct “a full existence and completeness baseline and rights baseline to ensure 100 percent reconciliation of our capital assets to our accountable property systems of record (floor-to-book, book-to floor)”; “a floor-to-book and book-to-floor physical inventory of all Working Capital Fund inventory and all General Fund munitions/ordnance and uninstalled engines in its possession;” and take additional steps to limit IT “system access to only those who need it.”

What is the plan going forward?

To conclude, this is just the beginning—the first of what has become an annual practice for the Department. In fact, as we continue to make progress in addressing the FY 2018 audit findings, we have launched the FY 2019 audit. Auditors are currently developing their testing plans and will commence site visits in June and July and deliver their report in November. We also look forward to delivering our mid-year update to Congress on June 30th.

The audit has been a dynamic catalyst for change within the Department—and we welcome the transparency it brings. In addition to the improvements it will continue to drive in real estate, inventory, equipment, and IT security, the audit will improve our financial integrity and decision making as well as providing a critical opportunity to leverage modern data analytics to improve every element of how we do business in the Department of Defense.

We are deeply committed to the long-term effort required to receive an unmodified opinion, and will continue to use closure of NFRs and the auditors' independent feedback as a measure of our success and progress toward a Department-wide unmodified opinion.

I would like to close by thanking the President for his deep commitment to this effort, Secretary Shanahan for his tireless support, the Inspector General for his partnership, and Congress and this Committee, both members and staff, for the key role you've played in making annual financial statement audits a reality for the Department of Defense. Not only have you worked with us closely throughout, but you have been a key part of the force in getting us here.

Thank you again for the opportunity to provide you with an update on the audit progress. We appreciate your continued support—and will need your sustained focus and attention as we move forward. Despite our substantial improvements, we know there will be no shortage of issues to tackle as we make annual audits the new normal at the Department of Defense.