

Statement of

The Honorable Robert F. Hale  
Under Secretary of Defense (Comptroller)

and

The Honorable Elizabeth A. McGrath  
Deputy Chief Management Officer  
Department of Defense

before the

House Armed Services Committee

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Mr. Chairman, Members of the Committee, thank you for your interest in financial management at the Department of Defense (DoD). We would particularly like to thank Chairman Conaway, his ranking associate Congressman Andrews, and all the members of the Defense Financial Management and Auditability Reform Panel. Their efforts have been helpful and constructive.

Ms. McGrath and I believe that we are making progress in improving DoD financial management and moving toward audit readiness. The personal commitment of Secretary Panetta has helped immeasurably and presents us with a golden opportunity to make continued progress. That said, there is much still to do and significant challenges lie ahead. The Panel's report highlights many of the challenges, and we agree with much of what is in that document.

Our statement today will focus on two related areas. First, at the request of the Panel, we will provide our perspectives on the panel's report, to include highlighting critical challenges and how we are addressing them. Second, we will convey our overall approach to auditability, including the key elements of our accelerated plan for achieving audit readiness for the Statement of Budgetary Resources (SBR) for general funds as well as our efforts to achieve audit readiness for all of DoD's financial statement audit readiness by 2017.

### **Perspectives on the Panel Report**

We find the Panel's report both balanced and constructive and appreciate the Panel's recognition of the significant progress made in overcoming the historic impediments to audit readiness.

We are particularly pleased that the Panel endorses our strategy and the methodology associated with our Financial Improvement and Audit Readiness (FIAR) efforts. By focusing first on the financial information DoD most uses to manage – particularly budgetary information and the counts and location of DoD assets -- we have achieved substantial “buy-in” and participation from both the financial and non-financial communities, enabling even greater progress.

The Panel report does express concern that, in order to achieve full auditability, we must do more than improve budgetary and asset information. Specifically, we must value all our assets at historical cost in order to achieve an auditable balance sheet. The report argues that our proposed method for valuation lacks sufficient detail. To an extent, this was intentional -- to keep the focus on our initial priorities. We do not want the Components to address balance sheet valuation until they achieve success on the SBR and on audits of the counts and location of assets (known to auditors as Existence and Completeness or E&C). The Components also need to have new financial systems in place before they approach asset validation. However,

recognizing the need for greater fidelity, we began to provide additional detail regarding asset valuation in our December 2011 updated FIAR guidance and will continue to develop our approach to valuation issues. Along with audit ready budget statements and E&C information, we believe that this guidance will help us move toward auditability for all our financial statements by 2017.

While we believe we have a way forward and have made significant progress since establishing our current strategic priorities, we accept the Panel's conclusion that we face significant challenges. The report identified five key areas where action is needed. The sections that follow describe each of these elements and the steps we are taking to mitigate and resolve them.

### *Sustained Leadership, Commitment, and Effective Oversight*

The first of these elements is sustained leadership, commitment, and effective oversight. Senior leadership commitment is important for setting the tone and priority for audit readiness, and the Secretary's recent directive has done just that. Furthermore, the Department's Strategic Management Plan (SMP) extends the Secretary's focus with an explicit goal: "Strengthen DoD Financial Management to respond to warfighter needs and sustain public confidence through auditable financial statements."

To oversee the implementation of the Secretary's directive, we will continue to use the governance structure established early in the current Administration. That structure includes involvement by the Deputy Secretary, a FIAR governance board co-chaired by the Chief Financial Officer and the Deputy Chief Management Officer, and subsidiary governance groups. This structure has been effective in driving and keeping the attention of senior leaders focused on financial management improvement. We recognize that our governance process needs to focus more on specific progress and must hold individuals accountable for that progress.

We will ask the Components to continue to commit to specific outcomes for each of their plans, and we will ask the same of service providers who support auditability. Those goals will be used to hold executives accountable at all levels of governance, and we intend to follow up on a regular basis to recognize successes and to identify and resolve the causes of any missed goals. We will also continue to use outside auditors to verify progress. We feel that, with these improvements to our governance process -- and Secretary Panetta's involvement -- we have the leadership commitment we need for more effective oversight and accountability.

We are well aware of the need to establish critical momentum this year, to ensure sustained continuity despite any leadership changes that may occur. Constructive Congressional oversight can also help to maintain continuity in the FIAR efforts.

We do face a major problem, and we ask any help that you can provide. This past year's budget uncertainty -- including no fewer than four threats of a government shutdown, which in

some cases generated enormous planning efforts, and now the prospect of sequester -- has drained valuable time and leadership attention from many initiatives, including our commitment to audit readiness. The Congress could help us a great deal by returning to a more orderly budget process.

### *Workforce Competency*

A second factor identified by the Panel involves DoD's professional financial management workforce. Today, our financial management team is capably supporting key mission needs around the world, but our business environment is changing, and we need to change our training to match that new environment. Financial management in the Department is moving away from a transaction-centric mission to one that focuses on analytical support for decision making -- all while the business environment is moving toward a more integrated setting.

We are taking steps to meet two new demands. In the short term we are delivering immediate practical training to both financial managers and non-financial operators on the importance of audit readiness. We are reinforcing these lessons through a partnership with the private sector personnel who are experienced in financial audits. Specifically, we are using examination engagements, which are an integral part of our audit readiness methodology, to get DoD personnel experience with the requirements for audit. These examinations are essentially small-scale audits of single business processes. The audit firms performing these engagements employ the same procedures used in audit, but on a smaller scope and scale. These "mock-audits" provide our employees with experience that cannot be taught.

For the long term, we are taking steps to sustain a strong defense financial management workforce through the establishment of a course-based certification program. This program will ensure that financial managers have the skill and experience in key areas of financial management, including financial statement audits. Some of our people have not had training and experience in audit areas, and we intend to help them get needed training through this program.

We appreciate Congressional passage of the law we needed to get this course-based certification program started. We received the required legislative authority as part of the Fiscal Year (FY) 2012 National Defense Authorization Act (NDAA), and we are now working aggressively to get the program started. Financial management is one of the first functional areas to have completed assessing core competencies, which will form the basis for this new certification program, and we are actively pursuing other planning. We expect to have pilots for this program in place by the end of this calendar year.

### *Implementation of Enterprise Resource Planning Systems*

Fielding of Enterprise Resource Planning (ERP) systems represents another important element of DoD's audit readiness strategy and our overall effort to improve DoD's business

operations. While the effective implementation of ERPs will not by itself enable auditability, it will help to achieve the modern business environment we need to meet and sustain the statutory requirement for audit readiness. As we have stated in previous testimony before your Panel and as the Government Accountability Office (GAO) and the Panel's report recognize, the Department has made substantial progress over the past two years in improving the way that we acquire and implement these ERPs.

Despite these recent advances, significant challenges must still be overcome. We appreciate the time and attention the Panel has given to ERPs and the thoughtful recommendations in its report. Effective ERP implementation is, and will remain, one of the Department's top priorities. In an era of tight budgets, it is more important than ever to provide ERP users with accurate and timely business information.

Because of the importance of these systems, we would like to comment further on three of the key themes the Panel report highlights through its findings and recommendations regarding our ERPs:

- As stated in our FIAR plan, we agree with the Panel's findings that it is extremely important to link our audit readiness efforts more closely with our ERP acquisition and implementation efforts. We have taken steps to enhance this linkage. For example, as stated in previous testimony, the Department is tying business outcomes to acquisition milestones and requiring that individual programs -- such as the Army's General Fund Enterprise Business System, the Navy ERP, and more recently, the Army's Global Combat Support System -- define the role that they play in their organizations' auditability efforts and end-to-end processes in their Acquisition Decision Memorandums. We believe that this enhanced linkage is an important step forward.
  - As an example, the Marine Corps has experienced operational success with the Global Combat Support System-Marine Corps (GCSS-MC) and recently requested approval to accelerate deployment. GCSS-MC is a portfolio of systems that supports logistics elements of command and control, joint logistics interoperability, and secure access to and visibility of logistics data, which is needed for achieving a clean audit. The program is currently deployed to 10,000 users and is demonstrating business value in several areas. For example, "Time to First Supply Status," a primary measure for logistics responsiveness, has been reduced from over 36 hours to an average of 6.2 hours at the units using GCSS-MC. Additionally, "Order Shipment Times" has been reduced by 22.9 percent and "Maintenance Repair Cycle Time" has been reduced by 64 percent.

- Equally encouraging, the Navy Enterprise Resource Planning (Navy ERP) program achieved a final deployment decision and is currently deploying to the remaining sites within the Navy. Navy ERP is an integrated business management system that modernizes, streamlines, and standardizes how the Navy manages people, money, programs, equipment, and supplies. At present, there are approximately 66,000 users worldwide, managing approximately 47 percent of the Navy's Total Obligation Authority. Navy ERP has enabled the retirement of 27 systems to date, with 69 more to be retired by 2016. This has garnered a realized cost avoidance of \$116 million from FY 2008 to FY 2010. The program is demonstrating business value in several areas. For example, the deployment of Navy ERP is enabling inventory reductions, real-time visibility of fleet assets, resources, and inventory, and improved financial management controls.
- The Panel report also highlights many of the challenges the Department faces in the acquisition of ERPs, such as cost estimation, requirements definition, and testing. Again, we agree that these are important issues, and we are taking steps to address them, consistent with lessons learned and industry best practices. For example, the better application of business process reengineering (BPR) methodology that has resulted from the integration of BPR assessments into our Investment Review Board (IRB) process, was mandated by the FY 2010 NDAA and is helping to define better and more stable requirements for our acquisition programs. By applying BPR early and up front in a program's lifecycle, we can ensure that the program has clearly identified and defined the business problem that the solution is intended to solve and is appropriately applying process, organization, and other solutions besides technology.
- The staff of the Deputy Chief Management Officer is also working with the testing and evaluation community to improve procedures for testing business systems, particularly Commercial-Off-the-Shelf products like the ERPs that have been tailored to meet DoD's non-commercial requirements. Our communities are working to develop test scenarios that are more consistent with end-to-end business processes, such as procure-to-pay. The goal is to ensure that our testing is thorough, expeditious, and tied to specific business outcomes, such as auditability.
- Your report also describes the challenges of ERP implementation within DoD's legacy environment. We agree that this is a difficult issue. Our new systems are in various stages of development and implementation, and therefore many of our legacy systems cannot yet be retired. The Panel report highlights the difficulties of data conversion when the quality of the legacy data is not equal to what is required

by modern ERPs and the need, in some cases, to institute multiple interfaces to legacy systems. These changes -- from old legacy systems to new ERPs, and from less structured data sets that are not interoperable, to more structured data sets that allow information to be exchanged across systems, aggregated, and analyzed -- cause increased manual workarounds and the re-inputting of data, as the report noted.

We would like to thank Congress for the changes to DoD's business systems IRBs, embodied in Section 901 of the FY 2012 NDAA. We view these changes as an important step in helping the Department accelerate the transition away from our legacy environment. This revised approach requires that the IRBs oversee our entire portfolio of business systems — not just systems under development or conducting modernization efforts, but legacy systems as well. The IRBs report directly to the Defense Business Systems Management Committee and the Deputy Secretary of Defense.

#### *Internal Control Weaknesses*

While critically important, improved financial systems will not by themselves eliminate our weaknesses and guarantee auditable statements. Achieving auditability also requires consistent process controls that cross organizations and functional areas. Business and financial information that is passed from system to system must be subject to a control environment. This environment ensures that only authorized personnel are using the system and that these systems protect the data quality and maintain an acceptable audit trail within the end-to-end business process. This process must be controlled at the transaction level, all the way from the source to the general ledger postings to accurate trial balances and reliable period closeouts. Only by completing these steps can we prepare financial statements that an auditor can review and verify without the need for audit sample sizes that are unaffordable. Many elements of our current business environment must be changed to allow us to meet these kinds of routine financial audit standards.

We also agree that we have more work to do in improving our financial reporting controls. Sound internal controls over financial reporting are the foundation of audit success, but we have sometimes found that ours are poorly documented and inconsistently executed.

What are we doing to address this problem? The primary improvement we have already made in this area is to enlist more help from the Service audit agencies. They have the personnel qualified to assess internal controls and to make sound recommendations for corrective actions. Each Service has developed a strategy and is applying significant personnel resources that will focus solely on evaluating controls at the operational level, recommend solutions for any issues identified, and then follow up to ensure rapid implementation of solutions.

Strengthening internal controls is critical for supporting financial auditability, and it will also further enhance the credibility of our reporting of key stewardship indicators such as improper payments. Because we put great management emphasis on payment excellence, our rates of improper payments are lower than most civilian agencies that have clean financial statement opinions. Our people have been focused on protecting federal funds, and we now ask them to apply that same rigor to all financial controls.

However, any amount of improper payments is too much. We can do better, specifically in the methodology that we use for detecting improper commercial payments. For example, to provide further assurance on our reporting and compliance with the Improper Payments Elimination and Recovery Act of 2010, we are now employing post-payment statistical sampling for all payment programs to include commercial pay. We will use this approach for reporting, effective this fiscal year, and use these reports to drive our improper payments closer towards zero.

A similar story emerges when we examine other indicators of financial management such as unmatched disbursements and Anti-Deficiency Act (ADA) violations. Over the past decade, DoD has markedly reduced its unmatched disbursements – only to see some recent increases caused by the time and training required to implement the new ERPs. While we have achieved substantial success, we can do more to reduce unmatched disbursements as we fix weaknesses caused by disconnected systems, inconsistent data, and poor management of system interfaces. In the case of ADAs, our violations are low compared to the non-defense agencies when ADAs are measured as a percentage of our budget. In the past couple of years we have also markedly reduced the number of ADA cases in the Department that take more than 15 months to process, and we think that timely enforcement will help deter violations. But again, we can and must do more to hold down ADA violations. We expect that the tightening of controls required to achieve auditable statements will help reduce the number of these violations.

### *Organizational Challenges*

In the past, the effort to improve financial information was seen solely as a CFO effort. Because financial transactions occur throughout the organization, the reality is that process, control, and system improvements, as well as personnel training must occur throughout the organization. Human resource organizations, for example, must take the lead in ensuring the accuracy of pay transactions, while the acquisition community must ensure that contracts are recorded in a timely manner and that adjustments and modifications are properly accounted for.

Our FIAR strategy, which focuses on information we use to manage, has already raised awareness of the audit effort in non-financial areas. We are also taking steps to institutionalize that higher profile. For example, we are requiring that the performance plans for all members of the Senior Executive Service (SES) must include a goal related to audit if an SES member is involved in the audit process. Because SES bonuses will now be tied to audit success, this shift

will help ensure that audit concerns extend beyond the financial community. The attention and direction from the Secretary of Defense has helped to create awareness in non-financial communities. This leadership from the top of the organization was a critical missing piece of our effort, and its presence will speed our progress.

More fundamentally, we must transform the FIAR effort from a comptroller's issue to a commander's issue, with financial managers providing advice and coordination. We are moving in that direction, but we need to do more.

### **Overall Approach to Auditability**

On October 13, 2011, Secretary Panetta issued a directive on auditability for DoD financial statements. The Secretary fully supported our overall approach to audit readiness, with its initial focus on the information we most use to manage, and supported our commitment to audit readiness for all DoD financial statements by 2017.

In his memo, Secretary Panetta also directed the Department to accelerate its efforts to achieve audit readiness, including cutting in half the time we had allotted to achieve an audit-ready Statement of Budgetary Resources for general funds. The Department is making several changes to meet Secretary Panetta's direction. We are also taking into account recent audits and examinations, including the Marine Corps audit of its Statement of Budgetary Resources, which have provided valuable lessons. In addition, the Panel's hearings and related testimony have proven timely and brought additional attention to bear, including suggestions on ways that the goals can be accelerated.

Based on these various inputs, we have created a plan for implementing the new timelines mandated by Secretary Panetta. The accelerated SBR plan will increase emphasis on interim milestones, including more attention to milestone details. The revised plan will also feature a heightened level of governance and accountability. Other changes as a result of the lessons learned and higher priorities include:

- More detailed integration of service provider plans (e.g., the Defense Finance and Accounting Service) with reporting Components;
- Shorter and more-focused discovery efforts to identify audit impediments;
- Concurrent work streams that were previously worked serially; and
- Increased emphasis on Defense Agency progress.

The Department is fully committed to meeting Secretary Panetta's ambitious goal. An overview of our accelerated plan was submitted to the Secretary in December, and we are now developing more details. In fact, Deputy Secretary Carter, along with the Service Under Secretaries and Vice Chiefs, will review the plan soon. Shortly after that, Secretary Panetta will

review the accelerated plan along with the Service Secretaries and Chiefs. These high-level reviews are indicative of the Department's commitment to audit readiness, and they may generate changes in the plans. We will provide more information after those reviews are complete, and we will provide full details in the next FIAR report to Congress in May.

We recognize that, in order to achieve audit readiness for all of our financial statements, we must go beyond our initial focus on audit readiness for budgetary statements and for asset counts and location. We are working to increase the detail regarding these other audit efforts, especially those related to asset valuation. We will continue to add detail over time as Components get closer to working on these initiatives.

But the key to achieving our 2017 goal is building a foundation using the current priorities and sustaining momentum. Auditable budget statements, and auditable counts and locations of assets, will build a strong foundation for full audit readiness. Involvement of commanders, and our governance structure and funding, will build momentum. With this wind behind our sails, we are reasonably confident that we can meet the 2017 goal for audit readiness for all DoD financial statements.

## **Conclusion**

We appreciate the Committee's interest and the Panel's suggestions for financial management improvement at the Department of Defense – as well as the hard work of DoD financial management personnel across the organization. We are making significant progress. The Department's senior leadership not only supports this effort; they are accelerating our program. And the organization is responding.

With regard to business operations, the Department does not turn on a dime. It is more like an aircraft carrier than a speedboat. But once an aircraft carrier gets going, it is tough to alter its momentum. We have a clearly focused Strategic Management Plan that establishes the course, and current priorities and resources will help manage our speed. Accordingly, we are reasonably confident that we have the momentum to achieve the auditability goals that lie before us and to do so within the prescribed timeframe.

We welcome your questions.