

# **FINANCIAL MANAGEMENT IN THE DEPARTMENT OF DEFENSE**

**No One is Accountable**

by Kwai Chan



## **SUMMARY**

**This report by Kwai Chan, the former Assistant Inspector General with the Environmental Protection Agency and the former Issue Area Director in the National Security and International Affairs Division in Government Accountability Office (GAO), documents that the Department of Defense's financial accounting systems remain so deeply flawed that there's little reason to expect improvement—much less a solution—to the Department's financial mess in the foreseeable future.**

## **AMONG OTHER THINGS, THE REPORT STATES:**

- The Defense Department is out of Compliance with the Chief Financial Officers (CFO) Act of 1990, which was passed to hold government agencies to the tough accounting practices applied to the private sector, and compliance is nowhere on the horizon.
  
- DOD does not know what it owns, where its inventory is located, and how its annual budget is being spent. The Department is not accountable to Congress or the American taxpayer.
  
- The Department of Defense's Office of Inspector General and the Government Accountability Office—which could be considered the public sector equivalents of accounting firms—share responsibility for the failure of the DOD to come into compliance with accounting laws. They have failed to specify the steps required of DOD to comply with basic accounting practices.
  
- Congress should grant the DOD Comptroller authority to hire and fire personnel as needed to accomplish the goal of bringing the DOD into compliance with generally accepted accounting principles. If the Comptroller—armed with the proper management authority to fix financial problems—then fails to achieve compliance, then he or she should be replaced by the President.

## **PREFACE**

### **A Business Perspective: Apply the Same Financial Standards to Government as the Private Sector**

*By*

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**T**he American people expect business leaders to abide by our nation's laws and set an example for the world about the integrity of our country. We know well what it means to run a large organization responsibly and efficiently.

In the United States, businesses must be financially accountable—or heads roll, whether companies are publicly-owned or not. And when businesspeople break our laws, we rightfully want them to face the same fate as Enron, Worldcomm, and the like.

**W**e expect the same financial accountability from our government.

Americans don't want a double-standard, in which government regulators rightfully police the private sector while government agencies are not held accountable. That's why President George W. Bush, the first CEO President, was so successful in his promise of running our government more like a business.

**T**his report by Kwai Chan the former Assistant Inspector General for Program Evaluation at the EPA and the former Issue Area Director in the National Security and International Affairs Division in Government Accountability Office (GAO), shows that the Pentagon's financial management system is an embarrassment. And worse, there's no fix in sight.

The Secretary of Defense cannot track inventory or expenditures, leaving him unable to report to his stockholders (taxpayers) how their money is being spent. And he can't report to his board of directors (Congress) how he's going to solve the problem.

As Chan writes, such financial disarray "would put any civilian company out of business." And top executives would surely be held accountable—in the boardroom and probably the courtroom as well.

**O**ur expertise is business, not military planning or weaponry. But we know that the productivity of any enterprise plummets if financial controls are not in place.

The bigger the budget, the more important it is that strict accounting discipline is adhered to. Otherwise massive waste, not to mention outright fraud, is not just a possibility, but a likely outcome.

Furthermore, a company plagued with financial ills is much more likely to be unable to set rational goals and priorities. So, in my mind, the Pentagon's accounting problems lend even more credibility to defense

analysts, like Lawrence J. Korb, President Ronald Reagan's Assistant Secretary of Defense, who have pointed out that tens of billions of dollars are wasted each year on weapons that have no military utility—and are irrelevant to fighting terrorists and the Iraq War.

**I**n the bigger picture, we think the American people, like America's business leaders, look at government as an investment, in our schools, environment, military, and elsewhere. No investor would put money in a company with no financial accountability. It's no wonder that many Americans don't trust their own government and resist paying taxes.

The financial mess at the Defense Department represents a betrayal of the trust of American taxpayers, who expect their government to follow the same basic financial practices as American businesses follow.

We hope this report will focus much-needed attention on the Pentagon's financial books, so that the problems will be addressed and the American people can begin to regain their trust in our government's largest department.

## INTRODUCTION

The Defense Department's financial management practices would put any civilian company out of business. And yet, few really know about it, and those who do know, do little about it. There have been some externally inspired measures to try to correct the very serious problems, but current spending abuses in the DOD show that improvement is slow to non-existent, and the future is bleak.

For the proposed 2007 budget, American taxpayers will pay \$441.2 billion to the Defense Department for its "baseline" budget—a 7 percent increase over 2006 and a 48 percent increase over 2001.<sup>1</sup> When one does the math, the proposed 2007 defense budget equals nearly \$1,500 for every man, woman, and child in America or about \$4,000 per household. The defense budget is even larger when contrasted to the analogous spending of other countries; DOD's fiscal year 2006 budget was more than the combined defense spending of the rest of the world.<sup>2</sup>

Given this amount of spending, American taxpayers should be confident that their money is being spent wisely. Unfortunately, there are few reasonable assurances that our tax dollars are not lost through fraud, waste, or abuse or that the DOD's financial management systems provide "complete, consistent, reliable, and timely information for [federal government] decision-makers."<sup>3</sup>

The recent report by the White House on the "Budget of the United States Government, fiscal year 2006" provides a telling summary of the DOD's neglect of the financial management of its own programs. With its internally developed Program Assessment Rating Tool

(PART), the Office of Management and Budget (OMB) assessed some 23 defense programs, including shipbuilding, missile defense, depot maintenance, housing, health, and air, land, and ship operations. For each of these programs, one simple question asked by OMB was whether the program uses strong financial management practices. Of the 23 programs assessed, the answers to 20 (87 percent) of them were "no."<sup>4</sup> With an 87 percent failure rate, reassuring conclusions should be questioned regarding the 13 percent of programs rated "strong financial management practices". Competent financial management practices do not insure that everything is fine, just that the major flaws can be found.

The Chief Financial Officers (CFO) Act of 1990 (P.L. 101-576) was meant to apply the financial discipline of the private industry to government agencies.<sup>5</sup> As required by the CFO Act, the government has a responsibility to use timely, reliable, and comprehensive financial information when making decisions. But in 2000, the assistant inspector general, Robert Lieberman, stated to Congress that his actions were stymied "by the compelling need to make deep workforce cuts rapidly and close many finance offices." Consequently, the CFO Act's accountability requirements could not be executed. As of Lieberman's testimony, the DOD had no concrete plans to become "CFO compliant." And five years later, it still does not. GAO fundamentally agrees, in 2004 it reported that DOD decision-makers are unable to assess "the implications of alternatives and improve the economy and efficiency of government operations."<sup>6</sup>

It remains unknown whether the Defense Department's expenditures have been in accordance with what it has been appropriated. American taxpayers do not even know whether the money has been spent in a manner consistent with DOD policy and directives. Nor can we

<sup>1</sup> This amount does not include money for operations in Iraq and Afghanistan; an additional \$50 billion in "bridge" funding will pay for part – about half – of the 2007 costs of the wars in those countries.

<sup>2</sup> Based on analysis of "The World Factbook," Central Intelligence Agency at: <http://www.cia.gov/cia/publications/factbook/index.html>.

<sup>3</sup> Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990.

<sup>4</sup> Budget of the United States Government, FY 2006; <http://www.whitehouse.gov/omb/ty2006>.

<sup>5</sup> Ibid.

<sup>6</sup> GAO/AFMD-12.19.4

<sup>7</sup> U.S. House of Representatives. Task Force on Defense and International Relations House Budget Committee. *Testimony of Robert J. Lieberman, Assistant Inspector General of Department of Defense: Department of Defense Financial Management, 20 July, 2000.*

begin to determine the magnitude of fraud, waste, or abuse. These are not just unmeasured but unmeasurable.

Some have tried to address these problems but have failed. Alongside the CFO Act, there was the formation of the Defense Finance and Accounting Service (DFAS) that centralized most of DOD's financial and accounting functions. However, the "usual problems" remained. Also, the Federal Financial Management Improvement Act of 1996 required agency heads to produce a Remediation Plan if their agencies' financial systems fail; and the National Defense Reauthorization Act of 1998 required the Secretary of Defense to submit a biennial plan to improve the financial problems of DOD. The secretary's biennial strategic plan is more like a 'report' than a 'plan,' rather than recommending and enforcing accountability, the report purports to show progress by issuing more reports.<sup>8</sup>

This type of non-result is typical. It mirrors the 1998 testimony of the former inspector general, Eleanor Hill, who stated, "It is remarkable how infrequently the DOD accounting community was asked questions along the lines of how much does it cost to run a base, fill a requisition or operate a warehouse."<sup>9</sup> And since then, there has been absolutely no progress toward a solution. As recently as 2004, Deputy IG Francis E. Reardon stated that the Defense Department "faces financial management problems that are long-standing, pervasive, and deeply rooted in virtually all operations." As a consequence, these problems "have impeded the Department's ability to provide reliable, timely, and useful financial and managerial data to support operating, budgeting, and policy decisions."<sup>10</sup>

In sum, the progress toward financial management competence between the enactment of the CFO Act in 1990 and 2004 has been nil.

In the private sector, unwise accounting practices have led to a number of spectacular disasters and scandals. The Enron and WorldCom examples are all too well known, and it is important to note that Arthur Andersen, LLP, the accounting firm that shredded its own documents involving its audit of Enron, has today virtually disappeared.

Today, if the Defense Department were a private business it would be involved in a major scandal. More to the point, it should be asked whether the DOD's Office of the Inspector General (OIG) and the Government Accountability Office (GAO) – the public sector equivalents to accounting firms – share responsibility.

## HAS THE OIG HELPED, OR HURT?

Each year, as recently as November 2005, the OIG has stated that DOD's financial statements "would not substantially conform to generally accepted accounting principles, and ...were unable to adequately support material amounts on the financial statements." The OIG stated that the DOD is un-auditable, and it could not perform the audits necessary to determine whether material amounts on the statements "were fairly presented."<sup>11</sup> As such, the Inspector General is unable to have an opinion about the finances or the internal control over financial reporting and compliance.

<sup>9</sup> U.S. House of Representatives. Subcommittee on Government Management Information Technology Committee on Government Reform and Oversight. *Testimony of Eleanor Hill, Inspector General of Department of Defense: Department of Defense Financial Management. 16 April, 1998.*

<sup>10</sup> U.S. House of Representative. Subcommittee on Financial Management, the Budget and International Security, Senate Committee on Governmental Affairs. *Statement of Francis E. Reardon. Deputy Inspector General for Auditing: Office of the Inspector General, Department of Defense. 8 July, 2004.*

<sup>11</sup> DoD Performance & Accountability Report, FY2005

Also, from 2003 to 2005, the Inspector General identified significant deficiencies in internal controls that could adversely affect the ability to accurately record, process, summarize, and report financial data. The following are 14 weaknesses identified by the OIG in the DOD's internal controls:<sup>12</sup>

- Financial Management Systems
- Fund Balance with Treasury
- Inventory
- Operating Materials and Supplies
- Property, Plant, and Equipment
- Government-Furnished Material and Contractor-Acquired Material
- Environmental Liabilities
- Intergovernmental Eliminations
- Accounting Entries
- Statement of Net Cost
- Statement of Financing
- Accounts Payable
- Accounts Receivable
- Contingent Legal Liabilities.<sup>13</sup>

By identifying these internal weaknesses the OIG should be able to make recommendations to remedy these problems; however, instead, the OIG opted to simply say the DOD is "un-auditable". That is insufficient. Remedies need to be identified. The American taxpayer does not have a reasonable assurance that the DOD's financial house will ever be in order because the OIG has not held the Defense Department accountable for making specific recommendations to repair the deficiencies.

However, the taxpayer is simultaneously told to have no fear. In the same testimony, Deputy IG Reardon

stated that senior financial managers in DOD are working toward achieving a favorable audit opinion by FY2007. In other words, the Department is given seventeen (17) years to achieve a favorable audit opinion, even though at the end of fourteen of those years there is no discernable progress.

## AND WHAT OF THE GAO?

In the face of this unending forbearance from the Defense Department's OIG, the Government Accountability Office, DOD's other "accounting firm," found that the Defense Department does not have a clear and realistic plan to make their goal of achieving a favorable audit opinion by FY2007.

For example, in their 2005 High-Risk Series, the GAO found inefficiencies and lack of transparency and accountability "across DOD's major business areas, resulting in billions of dollars in wasted resources." Specifically, GAO found weaknesses affecting DOD's ability to produce auditable financial information and to provide accurate and timely information for informed decision-making, including:

- In military pay, the GAO found some 94 percent of mobilized Army National Guard and Reserve soldiers had payroll problems.<sup>14</sup>
- GAO estimated that some \$100 million could be collected annually from DOD contractors that were abusing the federal tax system, but less than 1 percent—a little under \$700,000—of unpaid federal taxes had been collected through a mandated levy program.<sup>15</sup>
- GAO reported that the DOD is also incapable of tracking its own military supplies. In Operation Iraqi Freedom, the agency stated that the supply chain had

<sup>12</sup> Government Auditing Standards: Answers to Independence Standard Questions.; GAO-02-870G, July, 2002. Audit definition in [www.michigan.gov/techtalk/](http://www.michigan.gov/techtalk/); [www.austin.cctx.us/audit/Glossary/LetterR.htm](http://www.austin.cctx.us/audit/Glossary/LetterR.htm)

<sup>13</sup> DoD Performance & Accountability Report, FY2005, FY2004, FY2003, FY2002.

<sup>14</sup> GAO-04-89, "Military Pay: Army national Guard Personnel Mobilized to Active Duty Experienced Significant Pay Problems."

<sup>15</sup> GAO-04-414T, Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence."

a \$1.2 billion discrepancy in the amount of “supplies shipped to and received by Army activities.” DOD also lost millions in late fees to lease or replace storage containers due to distribution backlogs and losses. Consequently, military forces ended up short on basic items such as “tires, tank tracks, helicopter spare parts and radio batteries.”<sup>16</sup>

■ Despite these shortages, GAO found that more than half of DOD’s inventory, valued at about \$35 billion, exceeded their operational needs. They also found that the DOD is unable to give timely or accurate information on the “location, movement, status, or identity of its supplies.” In other words, while DOD doesn’t know where most of their supplies are, what condition they’re in, or even what they are, there’s \$35 billion in supplies and equipment that are not needed. Just like losing track of the money, DOD loses track of its supplies.

■ GAO estimated that DOD purchased at least \$100 million in airline tickets that it did not use and did not claim refunds from 1997 to 2003.<sup>17</sup>

In each case, however, GAO did not address a solution, as evident by the fact that it found 14 areas of high-risk in 1990, and has 25 areas of high-risk in 2005. Specifically, GAO’s response to the airline ticket problem was to not hold anyone accountable. Rather it asked the Defense Department to come up with a process to get refunds for unused tickets because the problem was caused by control weaknesses. This response demonstrates an approach where nothing is ever the fault of DOD managers or contractors; it’s just the nebulous process that is at fault – a process designed and managed by DOD officials and contractors.

Similarly, DOD has said that fixing the supply problem has been “a department-wide goal” for over 30 years, but claims it would not be able to achieve proper sup-

ply tracking until 2010. In other words, DOD has never been able to properly track the status and location of supplies but has recognized the seriousness of this problem as far back as 30 years ago! It now gives itself another five years to address the problem. Even so, GAO found that the Defense Department actually has no a plan to achieve its 2010 target.<sup>18</sup>

GAO is barely requiring the DOD to fix its problems – consequently it should share some blame in not helping the department to improve its financial structure. By not identifying and helping the taxpayer call to account the government and contractor managers responsible, is GAO living up to its own name, the Government Accountability Office, which it adopted after discarding its old moniker, the General Accounting Office?

## AND CONGRESS AND DOD MANAGERS?

**T**oday, Congress has brought itself to express some level of unease; it has placed a limitation on the funding for financial management improvement and audit initiatives until the Secretary submits a comprehensive and integrated financial improvement plan.<sup>19</sup> Unfortunately, the Congress only requested such a plan rather than holding the responsible officials accountable to comply with the law as intended in the CFO Act. Despite congressional concern, several government oversight reports, and much time, the Defense Department still has the same severe financial management problems – so much so that it seems to be an accepted part of the system. No one really pays much, if any, attention to the issue, not even the press.

How has the Defense Department responded to the permissive environment afforded by an inattentive press and a passive attitude in the OIG, the GAO, the press, and perhaps even Congress?

<sup>16</sup> GAO-05-207 High-Risk Update.

<sup>17</sup> GAO-04-398, “DOD Travel Cards: Control Weaknesses Led to Millions of Dollars Wasted on Unused Airline Tickets.”

<sup>18</sup> GAO-05-207, High-Risk Update.

<sup>19</sup> House of Representatives, Conference Report, “National Defense Authorization Act for Fiscal Year 2006, SEC. 376,” 109th Congress, Report 109-360, December 18, 2005.

DOD officials testify to Congress that managing the department is a huge job, that there are no equals in corporate America, that there are too many people to manage, that it relies on over 4,000 systems to conduct its business, that there is too much money with too many accounting systems to track, and that it will take years to solve. They tell us that they started with hundreds of accounting systems in 1990 and are now reducing the number to tens.<sup>20</sup> They, as well as the auditing entities, in their consistent refrain, would say that “progress has been made, but more needs to be done.”

The mission of the Department of Defense is to provide the military forces needed to provide a common defense of our country. With such solemn duties, issues such as financial management, cost growth, accountability, fraud, waste, and abuse are often treated as secondary issues and do not rise to the consciousness of the American people. Because of this, the DOD has taken a pass on fixing those issues time and time again.

## WHAT SHOULD BE DONE?

**T**he Under Secretary of Defense (Comptroller), serving as the chief financial officer of the department, has the responsibilities for maintaining effective control and accountability over the use of all financial resources, maintaining a management control program to control waste, fraud, loss, mismanagement, inefficiency, and demanding accuracy and reliability in accounting data and operating data.<sup>21</sup> The continued inability of the Defense Department to meet these basic responsibilities is simply not acceptable.

If, indeed, the Department’s senior managers are working toward achieving a favorable audit opinion by FY2007, Congress should hold them accountable. Specifically, Congress should call the comptroller to testify under oath on this promise. Congress should grant any additional authorities that the comptroller deems necessary to accomplish this goal, including the

need to hire and fire those managers overseeing the programs. Given these responsibilities and authorities, the comptroller should be held accountable for producing financial statements that would conform to generally accepted accounting principles. If the result is to the contrary, then the comptroller/CFO should be treated as if he or she is running a private corporation, and it would be time for the President to find a replacement. In the end, even though the Defense Department, the comptroller, and the OIG may seem like they’re accountable to no one, they actually are to someone: us, the taxpayers.

## About the Author

**K**wai-Cheung Chan is the former Assistant Inspector General for Program Evaluation in the Environmental Protection Agency from 2001 to 2005. As the first AIG to lead the newly established office, he is responsible to direct a multidisciplinary staff to conduct evaluations intended for the Congress, EPA, and the American people by addressing the most serious management challenges, promoting efficiency, and effectiveness of EPA programs, and contributing to improved environment and human health.

From 1990 to 2001, Mr. Chan served in the Program Evaluation and Methodology Division of GAO as the Director of Program Evaluation in Human Services Areas and later as the Director of Program Evaluation in Physical Systems Areas as well as the Director of Special Studies & Evaluations in the National Security and International Affairs Division in GAO.

Prior to joining GAO in 1978, Mr. Chan was a research analyst for 7 years with the Institute for Defense Analyses. From 1966 to 1971, he was a senior electronic engineer in the Advanced Technology Department in the General Dynamics Corporation and taught in the Graduate School of Applied Mathematics at the University of Rochester, Rochester, New York, for 3 years.

<sup>20</sup> In a prepared statement of John Hamre, Undersecretary of Defense (Comptroller), before the Subcommittee on Readiness, Senate Armed Services Committee, May 16, 1995, he stated “in 1990, DoD had some 250 finance and accounting systems, most incompatible with each other.” On the other hand, on April 16, 1998, Eleanor Hill, Inspector General of DoD, stated before the Subcommittee on Government Management Information Technology, House Committee on Government Reform and Oversight that “the Department is moving forward in reducing the number of accounting systems, which stood at 324 in 1991 and is down to 122 now. The goal is 23 by FY 2003.” There you have it. The Comptroller and the IG couldn’t even agree as to the number of financial systems they started with in 1990, when the CFO Act was passed.

<sup>21</sup> Department of Defense Directive number 5118.3, January 6, 1997.

Mr. Chan received his BS degree from Hobart College, New York, and Master Degrees in Mathematics from McGill University, Montreal, Canada and in Statistics from George Washington University, Washington, D.C.

Mr. Chan was conferred the rank of the Meritorious Executive in the Senior Executive Service in 1993.

Mr. Chan has testified before Congress on: chemical and biological defense, Gulf War illnesses, Operation Desert Storm, Agent Orange, Gulf War veterans, anthrax vaccine, Vaccine for Children Program, cholesterol measurement, technology transfer, military real property maintenance, and non-prescription drug. As invited speaker, he has spoken on: program evaluation, Program Assessment Rating Tool Process, enabling technologies for IFFN in urban warfare, live fire testing, technical risk assessment and management, the air campaign in Operation Desert Storm, Defense Operational Test & Evaluation, and the U.S. Strategic Triad.

He directed and worked on a number of studies and research in different areas. Examples include EPA Response to the World Trade Center Collapse, survey of the air quality information related to the WTC collapse, security of the nation's water infrastructure, New Source Review, Mercury emission from coal-fired electric utilities, environmental justice, asbestos, land mine detection, chemical accident safety, electric vehicles, quality assurance of medical technology, DOT auto crash tests, safety of the nation's blood supply, chemical warfare and the Binary Chemical Bomb, TOW missiles, Maverick IR missiles, digital satellite communication, and global positioning system.

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