

Embargoed until release by the
Senate Budget Committee

Testimony

Before the
Senate Budget Committee

The Audit of the Department of Defense

By
Mr. David Norquist,
Under Secretary of Defense (Comptroller) and Chief Financial Officer
Department of Defense

March 7, 2018

Testimony of the Honorable David Norquist on the Audit of the Department of Defense to the Senate Budget Committee, March 7, 2018

Introduction

Chairman Enzi, Ranking Member Sanders, and members of the Committee, thank you for the opportunity to provide an overview of the Department's financial statement audit progress and plans.

Before I begin, I want to take a moment to thank you and the rest of the Congress for the Bipartisan Budget Agreement of 2018. The Agreement raised the caps for Fiscal Years (FYs) 2018 and 2019 on defense spending to a level that will support the National Defense Strategy and allow us to restore and rebuild our military. It is a sign of how deep the hole is that we are in that an increase of \$85 billion in FY 2019 will just bring defense spending back to where it was in 2011 plus inflation. The agreement is a two-year deal, so we will need Congress' support again or sequestration will return in 2020.

When Secretary Mattis released the National Defense Strategy (NDS), he detailed three distinct lines of effort:

1. Build a more lethal, resilient, agile and ready Joint Force;
2. Strengthening alliances as we attract new partners; and
3. Reforming the Department's business practices for greater performance and affordability

This third line of effort relates directly to the audit. It is an important component in the improvement of our business operations.

The NDS section on reforming the Department states clearly that "The Department will continue its plan to achieve full auditability of all its operations, improving its financial processes, systems, and tool to understand, manage, and improve cost." **We anticipate auditor findings in many areas that is why we are doing these audits to find the problems and fix the root cause.**

I appreciate the Senate Budget Committee's interest in the audit of the Department of Defense: It is a long term, meaningful, and necessary undertaking that encompasses the whole of the Department and its success depends on

sustained congressional support. The personal interest Chairman Enzi and Senator Grassley and others on this Committee have shown in this issue are part of the reason DoD has, at long last, **begun the audit**.

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. Until this year, DoD was the only large federal agency not under full financial statement audit. The size and complexity of the enterprise, combined with the pace of military operations, made meeting this requirement challenging.

To reinforce the importance of this requirement, the National Defense Authorization Act for Fiscal Year (FY) 2014 mandated that DoD begin the audit in Fiscal Year 2018. Consistent with this requirement, in September 2017, we notified Congress 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.

What Does a Full Financial Statement Audit of DoD Entail?

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
- Testing system compliance with accounting standards and data interface deficiencies
- 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. However, **we won't have to wait for a clean opinion to derive benefits from 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.** Taxpayers deserve a high level of confidence 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 toward 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 of the Army, auditors 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 IT solutions.

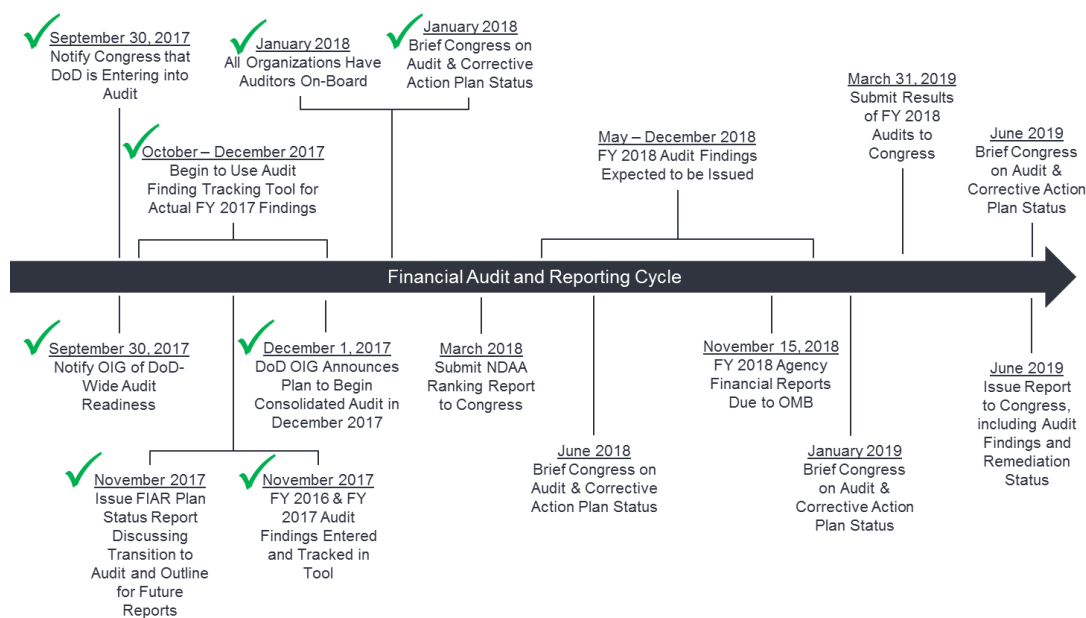
- 3) **Business Process Reform:** the combination of better data resulting from audit remediation, retirement of legacy systems, business process reengineering and the use of modern data analytics directly supports Congress' vision of the Chief Management Officer position and DoD's efforts to bring business reform to its operations. I view audit as an enabler that will drive more opportunities for Reform. 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 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 Corp. (IBM) pay their auditors. In addition, we anticipate spending about \$551 million in FY 2018 fixing problems identified by the auditors. These fixes include updating our records to reflect accurate count, condition and value of our real property, military equipment and supplies. It also includes fixing our systems' configurations for how they record accounting transactions. The remediation funding is spread across multiple organizations and business processes. For example, the Navy is spending approximately \$26 million this year to improve its valuation and accountability for \$369 billion in military equipment, supplies, and parts, to include ordnance, vessels, and aircraft. While \$26 million is a big dollar amount, the \$369 billion scope of this enterprise is enormous.

How the Audit Will be Conducted

The DoD consolidated audit is likely to be the largest audit 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. All audits are now underway and being conducted by the IPA firms. The DoD OIG is performing the consolidated audit. Auditors are close to completing their planning. Soon, they will begin familiarizing themselves with agency internal controls, and conducting statistical sampling. In some agencies they have already conducted site visits.

Fiscal Year 2018-2019 Timeline



Over the next 18 months, DoD will provide regular communication to Congress on the status of the audit and related remediation efforts

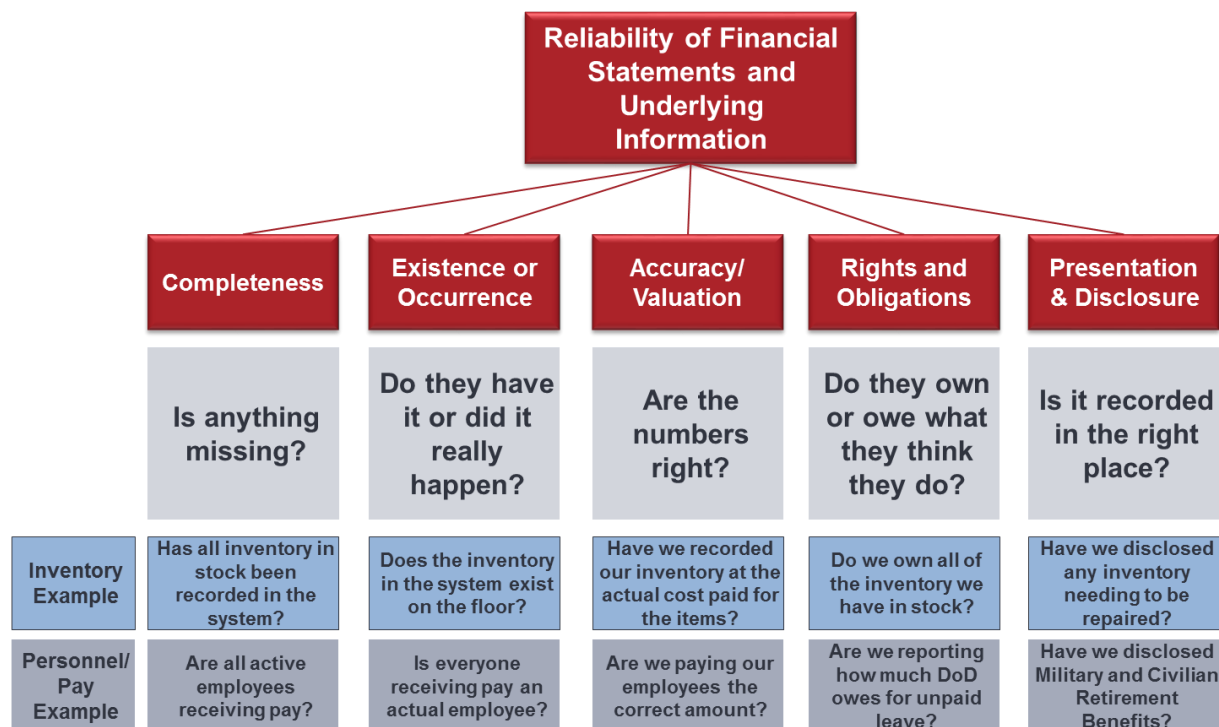
During an audit, auditors will select line items on financial statements based on materiality and risk, and will ask for a listing of items or transactions that make up the total amount on the financial statements. To put the scope of this task in perspective, the Army has over 15 billion transactions that the auditors will select from. With property, for example, the listing should have all the buildings, equipment, and software that equal the total value of property line on the financial statement.

The auditors will then pick samples from the listing for testing. For property, testing will include physically verifying that the property exists and is accurately recorded in the property system including the date acquired, working condition and depreciated value.

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 Auditor Looking For?

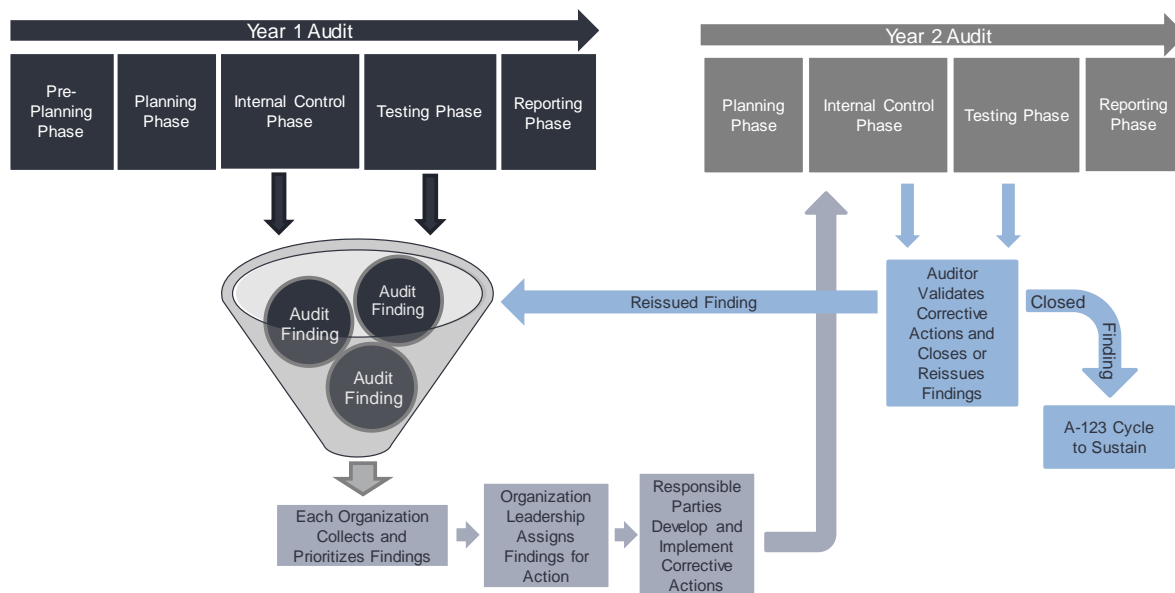


Measuring Progress

For years, the Department received a disclaimer of opinion on 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; they were not based on independent audit testing. Beginning this year, audit opinions will be based on comprehensive auditor testing and will result in actionable feedback. We expect to receive our first audit results in November 2018 and that will provide us with a baseline to track progress. We have an ongoing dialogue with GAO and as required by the NDAA, will be providing Congress with semi-annual feedback to update our 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, 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.**

DoD Audit Feedback Cycle



DoD is implementing an audit feedback cycle to respond to and maximize auditor feedback

Accurately Communicating Results

Some of the initial feedback we have received can be grouped into three main categories. The first category includes deficiencies in our basic accounting practices such as when transactions are incorrectly recorded or coded in the system due to systems capabilities or process weakness. For example, a recent Defense Logistics Agency (DLA) audit report identified \$465 million of construction projects misrepresented as “in progress”. These projects were, in fact, completed but miscoded in the system. This doesn’t mean DLA lost these construction funds or the real property assets. It means we need to improve our controls to ensure records are updated timely in the system and system configurations are fixed to correctly record and account for business events.

The second category reflects weaknesses in our business operations. By improving these business processes through standardization and more disciplined execution, the result should be improved timeliness and accuracy of our information along with increased asset visibility supporting better resource allocation decisions. For example, one audit finding indicated a problem with

DLA's oversight of large volume inventory and supplies. By increasing the quality and frequency of inventory counts, we will improve our visibility of location and availability of supplies and eliminating the risk of duplicate ordering of items.

The third category reflects weaknesses in internal controls over information systems. These are controls over access and security of our systems. For example, the auditors will test frequency by which we monitor who logs into our systems, whether the access is authorized and what changes these individuals can make to the system configuration. Remediation required to mitigate system security vulnerabilities does not save money but does help avoid future losses.

A common theme received from auditors across all categories is that in some cases management believed it had appropriate policies and procedures in place and personnel were following those procedures. However, either due to a lack of resources or past practices used locally, field personnel did not or could not follow the policies and believed this was understood by management. The audit closes that information gap.

Closing

In closing, I want to thank this Committee for its interest in and focus on the Department of Defense's audit. I anticipate the audit process will uncover many places where our controls or processes are broken. There will be unpleasant surprises. Some of these problems may also prove frustratingly difficult to fix. But the alternative is to operate in ignorance of the challenge and miss the opportunity to reform. Fixing these vulnerabilities is essential to avoid costly or destructive problems in the future. We are committed to the audit and to implementing the necessary reforms to be good stewards of the taxpayers' dollars. I appreciate your support.

I look forward to your questions.