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Financial Audit: Air Force Does Not Effectively
Account for Billions of Dollars of Resources

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Statement of
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Comptroller General of the United States

Before the
Committee on Armed Services
Subcommittee on Readiness
House of Representatives

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our recent efforts to audit the Air Force's fiscal year 1988 financial statements. This was the first time that a military service developed financial statements and provided them to GAO for audit. We are releasing our full report on our review to the Committee today, and our testimony will summarize some of the key results. Before discussing our findings, I would like to put into perspective why it is so important now that government agencies--particularly the Defense organizations--take the initiative to establish the kinds of systems, controls, and procedures needed to make them capable of producing acceptable financial statements that can be audited by an independent third party.

Quite simply, the successful preparation of financial statements demonstrates that an organization's systems and personnel are capable of accumulating, analyzing, summarizing, and reporting on its financial condition and operating results. This capability has long been demanded by the federal government for the private sector, and more recently for state and local government sectors as well. More recently, several of the major civil federal agencies have used financial statements as a key element in their efforts to bring financial control, accountability, and cost-effectiveness into their operations. These include GSA, the Departments of Veterans Affairs, Agriculture, and Labor, as well as the Social Security

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Administration. Most recently, HUD, in reaction to the scandals in its housing programs, has launched comprehensive initiatives to bring financial integrity to its operations. The development of financial statements for audit represents a cornerstone in HUD's strategy for doing this. However, the taxpayers should not be expected to wait for HUD scandals to occur on a case by case basis to get proper financial and accounting procedures implemented one agency at a time.

In candor, I have to tell you that getting federal organizations to prepare acceptable financial statements is not an easy task. Change does not come easily to federal operations. The federal government has always stressed appropriation accounting and fund control, in other words the budget process. This is certainly a critical part of government financial management; unfortunately, in many organizations, it may be the only part that is being seriously considered. In such situations, "How much can I spend?" overshadows the equally important question, "How well am I managing and controlling the resources I already have?" The latter question becomes even more important for DOD in today's environment of looming reductions to the defense budget. The military services are already responsible for huge amounts of assets; the Air Force alone is entrusted with assets reportedly valued at \$275 billion.

Similarly, today's environment will require greater emphasis on costs and how to control them. We have found that federal agencies' accounting systems do not routinely accumulate and report on the costs associated with their various operations.

Meaningful cost control requires knowing first what the costs being incurred are. Unfortunately, many federal agencies do not have accounting systems to provide this information in a systematic manner. Until they do, meaningful efforts to control costs and achieve financial efficiency cannot take place.

AIR FORCE FINANCIAL
SYSTEMS DO NOT PROVIDE
RELIABLE FINANCIAL DATA

Specifically, with regard to the Air Force, our audit noted that its accounting systems do not provide accurate cost data for almost 80 percent of its non-cash resources, such as weapons, inventory, and equipment. Its accounting and financial management systems can neither provide complete and reliable financial data nor be depended upon to report accurately on the resources entrusted to its managers. Much information that is produced is not timely. Financial reports can only be developed with extensive, time-consuming efforts to compile data from a variety of sources. These conditions adversely affected financial reporting and management at all levels, ranging from the Air Force

consolidated financial statements down to base-level financial reports.

The General Accounting and Finance System was intended to serve as the Air Force's general ledger, but a number of very significant accounts were not included. Certain data, such as aircraft values (\$82 billion) and missiles (\$10 billion) had to be derived from property systems and other data, such as accounts payable amounts (\$18 billion) and expense amounts (\$70 billion), was extracted of budgetary data rather than from a properly designed financial management system. In short, the Air Force does not have basic double entry accounting control over the bulk of its assets.

One result of these conditions is that financial reports to the Office of Management and Budget and the Treasury are also inaccurate and unreliable. In recent years, some Air Force components failed to submit financial data in time to be included in the year-end Treasury reports. As a result, March 31 data was used in lieu of missing September 30 data. Furthermore, over \$25 billion of Air Force assets were not included in financial reports to the Treasury and an additional \$10 billion in transactions were counted twice.

Air Force managers often did not take advantage of the limited financial information which was available to them. Analysis of the accounts used in preparing the financial reports showed obvious errors that were not corrected and were not investigated to determine if a problem existed. As a minimum, obvious mistakes and significant changes in account balances should be followed up to make sure that serious problems are addressed. Some examples of accounts that warranted further review are:

-- The disbursement accounts at the Air Force Systems Command declined by 64 percent between fiscal year 1987 and 1988. This could indicate that information is not being properly reported by payment centers or that the rate of progress payments is slowing. Management needs to monitor the contracts more closely based on these data. The disbursement account decreased at the Aeronautical Systems Division by 97 percent, but increased at the Rome Air Development Center. For the same account, another component--the Space Systems Division--reported a zero account balance at the end of the fiscal year. Obviously, the Command needed to follow up on the activity in this account to determine the abnormal changes and reporting by its components. Air Force officials had no explanations for the variances.

-- Air bases reported credit (negative) balances of some inventory accounts and construction-in-progress accounts. Negative values for such asset accounts indicate with virtual certainty that they are incorrect. Yet management did not investigate the cause of these erroneous balances, and accordingly, accounting records and reports for these assets were of limited or no value to Air Force managers.

We also found that billions of dollars in adjustments to the accounting records were made which could not be supported or explained by Air Force officials. There can be legitimate and necessary purposes for adjustments. For example, if a control account balance does not agree with the total per its underlying records, the two balances should be investigated and reconciled, and appropriate adjustments made to correct the errors causing the out of balance condition. However, without adequate safeguards, adjustments can also be used improperly to cover up defalcations, hide losses, or mask errors. Examples of improper adjustments and lack of reconciliations were:

-- The Space Systems Division's trial balance for March 31, 1988 differed from its subsidiary records by \$2.4 billion. In order to get the two systems to agree, they "plugged" the accounts. In other words, they made an unsupported adjustment for \$2.4 billion, without finding out why the

records did not agree. Further, they had not reconciled detailed contract files with the payments to contractors for about 2 years. This reconciliation is a key control in ensuring payments do not exceed obligations on contracts and that funds are properly spent. As a result, accountability was lost and the opportunity to deal with possible instances of mismanagement, fraud, or abuse was missed.

-- Similarly, at the Systems Command, our audit tests disclosed unsupported adjustments of \$500,000 that were made increasing the obligation and expenditure accounts for Operations and Maintenance appropriations in September 1988. These adjustments used previously available fund authority without documentation. Officials could not explain the adjustments, nor could they find any documentation to show why they were made.

-- At Warner Robins Air Logistics Center, control accounts were not routinely reconciled with supporting records. One account balance had a negative balance of \$2.1 billion, although the account balance should normally be positive or zero. The general ledger accountant said that he had no documentation to support the account balance and that the account had been in error since 1983.

-- At Sembach Air Force Base, we found that over \$214,000 in undocumented adjustments, a material amount for an air base, were made to force control accounts to agree with subsidiary records. When we researched these adjustments, we found that some of the unsupported adjustments were attributed to the actions of a disgruntled employee in the finance office who failed to properly process transactions, entered erroneous data, and destroyed source documents. This case is being investigated to determine whether fraud occurred.

-- At three ALCs, the interfaces between the perpetual inventory tracking system and inventory accounting system did not function properly. As a result, the two systems reported different amounts on hand for the same items. To compensate, either each month or each quarter, the ALC's accounting and finance office adjusted the accounts in the inventory accounting system to force them to agree with the perpetual inventory tracking system's balances. However, the discrepancies between the systems were not researched to determine their causes. The net effect of such adjustments for fiscal year 1988 decreased the inventory accounts by about \$361 million. At our request, Ogden ALC officials researched \$241 million of its September 30, 1988, adjustments and found that \$114 million was the result of inventory system errors, while \$127 million

resulted from coding and timing errors. These errors had been masked by the improper adjustments and would not likely have been detected had we not asked base officials to investigate.

FULL COSTS OF WEAPONS SYSTEMS

NOT ACCUMULATED AND REPORTED

The development and acquisition of weapons systems represents a major fiscal commitment for DOD and the taxpayers. One of the greatest challenges facing DOD today is to manage reduced spending after a period of large peacetime defense buildup. Since the mid-1980s, DOD's five-year defense planning has been fiscally unrealistic. More weapons were being planned and developed than could be produced in an economic manner or supported once they were produced. Since 1982, DOD five-year spending plans have exceeded actual and current estimated funding by over \$2 trillion. This is not an effective way for DOD to manage, nor does it facilitate congressional oversight of the defense budget.

The Air Force's costs of weapons systems reported in the accounting system are vastly understated. Aircraft, missiles, and engines are valued at estimated standard or purported "average acquisition" costs which do not reflect actual costs incurred to acquire the items. We compared the accounting system costs to Selected Acquisition Reports (SARs) and to expenditures from the

budgetary reports and found that actual costs are not recorded in the accounting systems. For example, the B-1B bomber is recorded in the accounting system at \$150 million each. The SARs reported \$215 million for each, and we estimated \$219 million each. While the SARs costs more closely approximated our estimate of actual costs, we have previously reported that the SARs do not adequately disclose all costs associated with major weapons systems. For example, SARs often do not include actual contractor costs incurred to date or a schedule comparing funded quantities to planned and actual contractor deliveries. The SARs also do not reflect anticipated, but not yet approved, cost estimate changes.

The SARs costs are derived from Air Force budgetary data, as are other documents the Air Force uses to portray weapons systems costs. However, OMB Circular A-127 requires that budgeting and accounting should be done on the same basis through integrated budgeting and accounting systems. Cost information, whether reported in general ledger accounts and financial reports or SARs, should be consistent. There should not be a variety of different numbers for similar items to choose from.

Other costs that were not included in the weapons systems valuations are:

-- Government-furnished materials, such as parts, components, assemblies and raw materials, provided to contractors and incorporated into the weapons systems are not included in the value of the end items. We have previously reported that long-standing problems in controlling and accounting for government-furnished materials preclude DOD from knowing the exact amount of these items in contractors' hands. DOD and the services have no overall management or financial systems to independently verify contractor records and measure the value of government-furnished materials ultimately included in end items.

-- Over \$25 billion of modifications which enhance the mission capabilities and/or extend the service life of weapons systems generally are not included in the valuation of the assets.

Additionally, the Air Force accounting systems do not capture all operating and support costs associated with weapons systems. In 1987, the Senate Committee on Appropriations expressed its concern over the long-term implications of procuring weapons systems which have increasingly expensive operating and support costs. During that same year, we attempted

to review such costs but were forced to terminate the review because the needed cost data were simply not available. There is no logical reason in today's world that a large, complex organization such as the Air Force should not have a sound cost accounting system. Such a system is absolutely essential for measuring costs and improving efficiency.

INVENTORY SYSTEMS DO NOT
PROVIDE ACCURATE DATA

Inventory management for the Air Force is an extremely complex task due to the size of its operations, frequent technological obsolescence, and decentralization of storage for national security reasons. To maintain and support its operations and weapons systems, the Air Force manages about 1.6 million different spare parts and supply items valued at about \$64 billion. This is about eight times larger than the inventories reported by General Motors. Unfortunately, systems used to track and value these immense inventories do not maintain accurate data supporting either the quantities or values. Yet these are the systems upon which managers must depend in determining whether new items need to be purchased. Using inaccurate information to base purchase decisions can result in unnecessary procurements and excess inventories in some instances, and shortages in others.

Excess Inventories Are Increasing

Unrequired inventories have grown tremendously in the 1980s. The Air Force is estimated to have at least \$10 billion of unrequired inventory. The growth in unrequired inventory is related to several factors. The most common causes of this growth are overestimated use rates and modifications of aircraft and equipment. Other causes include faster than expected phase-outs of older aircraft, fluctuating war reserve and safety level requirements, improved item reliability, and items being reclassified as repairable. Also, orders for items in excess of requirements were not terminated, and procurement lead times were overestimated. This problem is not Air Force specific; the amount of excess inventory in the Department of Defense as a whole is estimated at \$29 billion. We currently have ongoing work that will address matters related to inventory on a DOD-wide basis.

Inadequate Accountability Precludes

Effective Inventory Management

Accountability systems used to track the location and quantities of over half the Air Force's inventory items do not provide reliable, accurate inventory data to managers. Inaccurate inventory records can cause critical supply shortages, prolonged delays in filling requisitions, or unnecessary

procurements resulting in accumulation of excess inventory.

Although the Air Force has recently improved the accuracy of its data in automated perpetual inventory systems and generally takes accurate physical inventory counts, we believe the perpetual records are still too unreliable for managers to use in their attempt to make effective and efficient decisions.

Inventory Valuations

Are Inaccurate

The Air Force did not consistently apply its inventory pricing policies to value inventories of investment items. The Air Force assigns values to inventories of spare parts and supplies based on the item's latest acquisition cost. Basically, the Air Force multiplies this cost times the number of units in stock to arrive at the total inventory value. Air Force policy states that the standard price generally represents the last acquisition cost of an inventory item plus a surcharge for government-furnished materials and transportation costs. Therefore, all items of a particular stock number are valued at the same price.

Under this practice, when items are purchased at higher prices, the values of all such items are adjusted upward. Unless the accounting statements reflect such increases as occurring from changes in valuation, they are misleading because the

readers cannot readily determine whether the growth represents an increase in items on hand or simply increased values of current stock.

Inventory Values Are Not
Adjusted for Condition

Inventory values are not adjusted to reflect the condition of the items in inventory. Although about \$7 billion of the inventory items at the three ALC's we visited were unserviceable, they were valued the same as new inventory items. This practice results in a significant overstatement of inventory values and is misleading because (1) the true inventory value is less than shown and (2) there is a substantial additional cost to bring unserviceable items to usable condition.

The military services maintain a large number of unserviceable items in their inventories for a variety of reasons. For example, components that are very expensive to repair and not in high demand can be better controlled and scheduled for repair only when needed. The Air Force has determined that it is more efficient to maintain the unusable item under normal inventory control and repair it when necessary. Although this approach may be effective for certain inventory management purposes, it is not acceptable for financial reporting purposes. To show these items at the same value as fully

serviceable items, when many require the investment of significant dollars before they can be used, distorts the financial statements. The Air Force needs to develop a methodology to regularly adjust the unserviceable portion of its inventory to reflect costs associated with repairing the items.

FINANCIAL STATEMENTS AND
AUDITS SHOULD BE REQUIRED
FOR ALL FEDERAL AGENCIES

The Air Force audit illustrates why we do need reliable financial statements for federal agencies. There are still some who insist that traditional federal financial management practices are adequate and that financial statements and audits are not needed in federal operations. I would like to put these notions to rest.

Almost universally, our financial audits of civil agencies, as well as the Air Force, have revealed systems problems which are so severe that the financial information needed to manage agency operations as well as prepare agency financial statements are seriously deficient. These problems are generally more serious and deep-seated than either we or the agency managers realized before the audit. We believe the process of trying to prepare financial statements forces full recognition of the systems problems. The process is like an early warning system,

an often overlooked value which derives from the preparation of agency financial statements.

Our financial audits have disclosed that those systems which do exist are not designed to aid government managers to operate in a cost-effective manner or to prevent mismanagement, fraud, waste, and abuse. These essentials must be addressed when reliable financial statements must be prepared. This is because statements cannot be prepared without addressing systems issues and related internal controls.

Reliable cost information needed to manage in a cost-effective manner flows from the good accounting systems necessary to prepare financial statements. Management controls which operate to prevent mismanagement, fraud, waste, and abuse are also required to produce reliable financial statements. The appalling list of high-risk areas recently published by OMB highlights the need for reliable financial statements prepared by federal agencies. Many of the items OMB identified result from or are related to accounting systems problems.

Why can't the agencies just fix the systems and not bother with financial statements? Theoretically possible, but practically impossible. The agencies need the discipline of having to prepare reliable financial statements which satisfy standards set by independent auditors in order to focus on fixing

the underlying systems. One might view audited financial statements as a report card which will point out seriously deficient systems, help quantify the extent of the problem, and highlight what needs to be done. Until an agency can achieve unqualified financial statements, its systems will be seriously deficient, the information derived from those systems that goes to the Congress and others will be incorrect, and it cannot be cost-effective. That's the financial statement report card.

Also, I want to emphasize that improving financial management in the federal government has been an important objective of GAO, OMB, and Treasury. In 1988, the Secretary of the Treasury; Director, Office of Management and Budget; and I collectively issued standards for core financial system requirements. Those standards represent a major step in improving federal financial management systems and will provide greater consistency and reliability to department and agency financial systems and improve financial reporting.

What we have found in our audits of the Air Force and other agencies and government corporations is that the true financial situation of these entities had not been disclosed to the public, the Congress, OMB, and the Treasury. What we have found is that the agency managers did not understand the financial condition of their agencies before they tried to produce auditable financial statements. As the report

demonstrates, the financial information reported to the Congress and OMB by the Air Force was wrong by significant amounts.

In addition, we noted that Air Force statement line items should be adjusted by amounts which are not calculable at this point in time. We roughly estimate that equipment and missiles are misstated by billions of dollars, and aircraft and inventories are misstated by tens of billions of dollars.

Moreover, additional analysis during our fiscal year 1989 audit shows that the budgetary system processed about \$12 billion in budgetary transactions (expenditures) in 1988 that was not recorded in the general ledger accounting system. For fiscal year 1989, we estimate that an additional \$23 billion was not recorded in the system. Air Force finance officials estimate that several billions of dollars of expenditures were for classified assets which are not recorded in the accounting system for security reasons. While they could not specify the amounts for the remaining expenditures, they agreed that they represent assets that are (1) recorded in the accounting systems at different costs than actually incurred (e.g., weapons systems), (2) government-furnished materials provided to contractors, and (3) consumed inventories.

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Despite the conditions I have described, I would like to end my testimony on a positive note. The Air Force showed initiative and leadership in being the first DOD organization to attempt to prepare financial statements. That task proved to be more formidable than either GAO or the Air Force anticipated; nonetheless, both of us have learned a great deal and much has been accomplished. Our report provides a blueprint for corrective action and DOD has concurred or partially concurred with all of our recommendations. You may be sure that we will continue our efforts with the Air Force to improve its financial operations, and it is our intention to review the Army next and later the Navy.

Mr. Chairman, this concludes my prepared statement. I will be pleased to answer any questions from you and other Committee members.