# Message from the Deputy Secretary of Defense

January 31, 2003

I am pleased to present the Department of Defense fiscal year 2002 Performance and Accountability Report.

This report documents the Department's progress in transforming America's defense posture to enable us to address future security challenges more decisively. Most significantly, we have developed and are implementing a new defense strategy and have begun to enhance military capabilities to focus more on 21st century threats – all while fighting a war on terrorism. We also are transforming our support structure and management practices. This overhaul of Department operations is the primary focus of this report.

This report reflects many important initiatives. In fiscal year 2002 we deployed the world's largest personnel management data system. We are modernizing financial systems, working to upgrade facilities, advancing private-public partnerships in military housing, eliminating unnecessary advisory boards, practicing realistic budgeting, increasing our focus on core support functions, and reforming our annual review of programs and funding. We also are working closely with the Office of Management and Budget and the General Accounting Office to develop measurable annual performance goals and objectives that fully support our new defense priorities.

The Department is committed to effective internal controls, full compliance with established guidelines and standards, and proper stewardship of the resources entrusted to it. Except for the weaknesses noted in Part I of this report, the Department has reasonable assurance that its management controls are effective. I am confident that the Department is prepared to fulfill its mission responsibilities.

Looking ahead, the Department must further intensify the transformation of its support structure and management practices. We must continue to upgrade performance and accountability, streamline and strengthen management, and ensure that every defense dollar is expended as wisely as possible.

Paul Wolfowitz

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# Part I

# Management's Discussion and Analysis

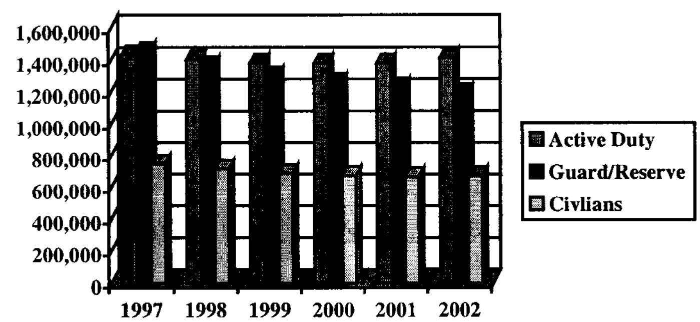
# DoD Mission and Organization Structure

# Mission

The mission of the U.S. Armed Forces is to protect and advance U.S. security and national interests, to deter aggressors and, if deterrence fails, to defeat any adversary.

# Our Resources

The Department of Defense (DoD) is the nation's largest employer, with 1.4 million men and women currently on active duty, another 1.2 million serving in the Reserve and Guard Components, and 675,000 civilians, as of July 31, 2002. We have a worldwide presence with over 473,800 military and civilian personnel deployed and stationed in more than 146 countries.




Number of personnel in millions

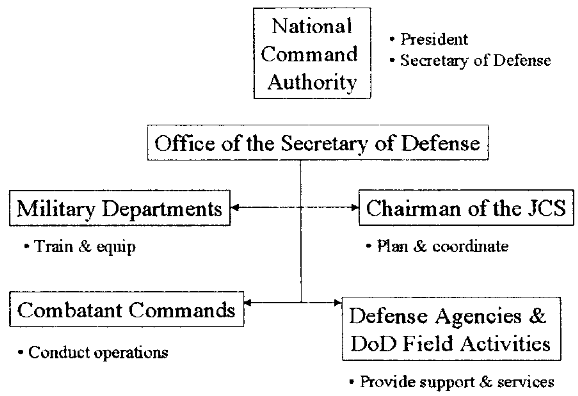
The Department maintains a robust infrastructure, operating more than 600,000 individual buildings and structures located at more than 6,000 different locations and using more than 30 million acres.

The Department's size, structure, and resources easily make it one of the largest industries in the world. It expended approximately $371 billion to operate and maintain about 250,000 vehicles, over 15,000 aircraft, more than 1,000 oceangoing vessels, and some 550 public utility systems.

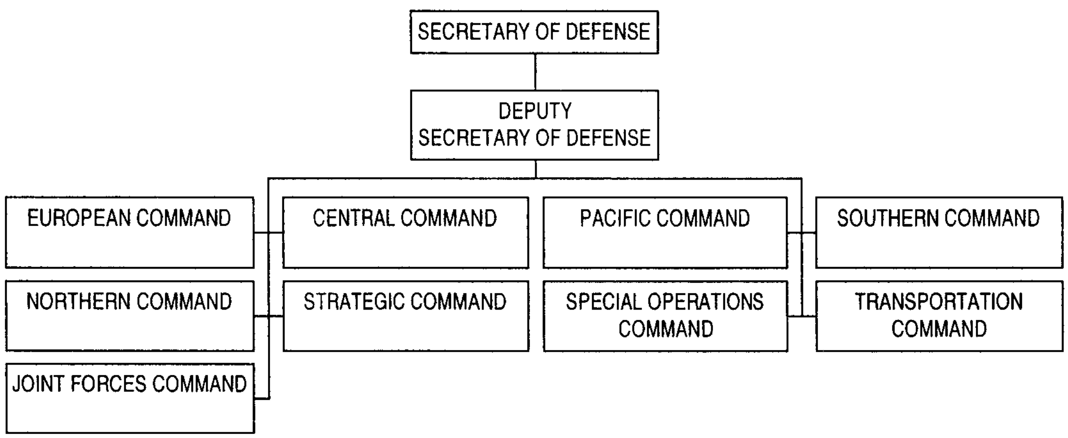
# Our Organization

The Department of Defense is a Cabinet-level organization that receives orders from the President of the United States. The Secretary of Defense is appointed by the President and is responsible for the formulation and execution of defense policy.

The Office of the Secretary of Defense (OSD) carries out the Secretary's policies by tasking the Military Departments, the Chairman of the Joint Chiefs, the Combatant Commands, and the Defense Agencies and DoD Field Activities. The Military Departments train and equip their forces, while the Joint Chiefs of Staff plan and coordinate deployments and operations that are conducted by the Combatant Commands. The Defense Agencies and DoD Field Activities perform selected support and service functions on a Department-wide basis.




# *Combatant Commands*




The Secretary of Defense uses the military command structure to deploy troops and authorize the use of military power by providing direction, through the Chairman of the JCS, to his nine combatant commanders. Six of the commanders have regional responsibilities, while the remaining three have worldwide responsibility. The events of September 11, 2001, and the ensuing war on terrorism, as well as the new defense strategy articulated in the 2001 Quadrennial Defense Review, highlighted the need to change the structure and responsibilities of the Combatant Commands. As a result, the Department created a new Combatant Command, the U.S. Northern Command, assigned to defend the United States and support the full range of military assistance to domestic civil authorities. U.S. Joint Forces Command transferred its geographic areas of responsibility to U.S. Northern Command and U.S. European Command, thus enabling U.S. Joint Forces Commanc to focus on joint experimentation and transforming U.S. military forces. In addition, U.S. Space Command and U.S. Strategic Command were merged to form a new U.S. Strategic Command. These changes will better prepare the nation to defend against new and emerging threats.

## *The Military Departments*

**Army, Navy and Air Force.** The three Military Departments--the Army, the Navy and the Air Force-- recruit, train, and equip combat forces. The Marine Corps, our main amphibious force, is a component of the Navy. These trained and ready forces are then assigned to a combatant commander for the conduct of military operations.

**Reserve Components**. The Reserve Components' forces comprise approximately half of America's total uniformed force. Within the last decade, National Guard and Reserve Component personnel have taken on new and more important roles in wartime military support, as well as humanitarian, peacekeeping, law enforcement, and disaster assistance missions. Their importance was especially highlighted after the events of September 11, 2001, as they provided extra air patrols, and security forces personnel on the ground.

**Defense Agencies and DoD Field Activities.** Defense Agencies and DoD Field Activities provide a supply or service activity to more than one military department. Examples are accounting service, payroll service, information computing service, and logistics support. The consolidation of supply and service functions has improved efficiency and saved money. There are currently 15 Defense Agencies and 7 DoD Field Activities.

# Performance Highlights

President Bush is committed to restoring the strength and vitality of the Armed Forces. After a period of declining readiness, the new administration, with the support of Congress, is rebuilding U.S. military capability and transforming America's defense for the 21st century.

The Department is acting on the President's challenge to develop new capabilities to overcome new threats facing our nation. We reassessed the dangers and opportunities inherent in a changing international security environment, and are implementing a strategy to address those changes.

In the past year, the Department of Defense:

- Adopted a new defense strategy;
- Replaced a 10-year old concept for determining the size of the Armed Forces that was based on *whom* we will fight with a new concept based on *how* we will fight;
- Reorganized and revitalized the missile defense research and testing program, free of the constraints of the Anti-Ballistic Missile Treaty;
- Reorganized to provide better focus on intelligence and space capabilities;
- Fashioned a new Unified Command Plan to enhance homeland defense and accelerate transformation;
- Adopted a new approach to strategic deterrence through the Nuclear Posture Review; and
- Adopted a new approach to balancing risks.

These achievements represent significant progress in the Department's efforts to transform itself, especially since they were accomplished while fighting an unexpected war on terrorism.

# Looking to the Future

The 2001 *Quadrennial Defense Review* (QDR) analyzed the risks and opportunities in the global security environment and articulated a new defense strategy designed to:

- Defend the United States;
- Deter aggression and coercion forward in critical regions;
- Swiftly defeat aggression in overlapping major conflicts while preserving for the President the option to call for a decisive victory in one of those conflicts – including the possiblity of regime change or occupation; and
- Conduct a limited number of smaller-scale contingency operations.

The Department largely completed the QDR and its accompanying report before the September 11, 2001, terror attacks on the United States. In important ways, the attacks confirmed the strategic direction and planning principles that resulted from the QDR, particularly its emphasis on homeland defense, preparing for asymmetric threats, the need to develop new concepts of deterrence, the need for a capabilities-based strategy, and the need to balance the different dimensions of risk. Moreover, the terrorist attacks on the United States have compelled the Department to move forward more rapidly in these directions, even as the United States is engaged in the war on terrorism.

The Secretary of Defense's 2002 *Annual Report to the President and Congress* details the likely effect of existing and future conditions on U.S. security. It also highlights actions that will be taken to enhance DoD's performance in meeting its security responsibilities, as well as its responsibilities for managing the property, finances, people, and other assets entrusted to its care by the American public.

The common thread in these reports is the importance of transforming America's defense posture to enable us to counter 21st century threats most effectively. Transformation includes new military capabilities and new ways of fighting, as well as overhauling the Department's management and support activities.

The Department is organizing its actions to enhance performance around the concept of reducing the following four risk areas in a balanced way.

## *Reducing Force Management Risk*

The Department must recruit, retain, train, and equip sufficient numbers of quality people to sustain a ready force while accomplishing its day-to-day mission. Accordingly, it must: ensure adequate funding for military and civilian compensation, effectively manage personnel deployments and military unit operations, establish a flexible and joint system of civilian human resources management, provide realistic funding for weapons systems and day-to-day operations, and ensure prudent funding and control of contingency operations.

## *Reducing Operational Risk*

The Department must build a broader range of military capabilities for a wide spectrum of functional and geographical requirements. It must relieve the demands on personnel and equipment that are used frequently but that are in short supply (low-density/high-demand assets), such as unmanned aircraft and chemical and biological defense units.

## *Reducing Future Challenges Risk*

The Department must accelerate the transformation of its military forces – developing and fielding promising technologies, experimenting with new concepts of operations and emphasizing scientific research to prepare for the most significant challenges that U.S. forces may face in the future.

## *Reducing Institutional Risk*

The Department must streamline and increase the effectiveness of its management and support activities. Critical actions include: modernizing business practices; improving the management of acquisition, technology, and logistics; right-sizing and upgrading DoD installations and facilities; overhauling financial management; revising the program review process; and improving performance measures.

# Financial Statements Highlights

## Limitations

The DoD financial statements for fiscal year (FY) 2002 have been prepared to report the financial position and results of operations, pursuant to the requirements of the "Chief Financial Officers Act of 1990" and the "Government Management Reform Act of 1994." The DoD statements should be read with the understanding that they are for a component of the U.S. Government. The financial statements are not intended to replace the financial reports used to monitor and control budgetary resources.

To the extent possible, the financial statements have been prepared in accordance with federal accounting standards. At times, the Department is unable to implement all elements of the standards due to the limitations of its financial management systems. The Department is engaged in a Financial Management Modernization Program in order to implement system improvements to address these limitations. Under the auspices of this Program, the Department is in the process of creating a Department-wide technical design (enterprise architecture) that will prescribe how DoD's business processes will interact to ensure that all financial information is reported. This architecture will guide the development of enterprise-level business processes and systems throughout the Department that are compliant with the Federal Financial Management Improvement Act, Generally Accepted Accounting Principles, federal accounting standards, and the U.S. Government Standard General Ledger..

## Financial Statement Analysis

The Department's goal is to produce timely, accurate and reliable financial information that can be used to manage operations, and as a by-product, achieve unqualified audit opinions on financial statements. While the Department's auditors issued a disclaimer of opinion on its Agency-wide Financial Statements, a number of the Department's subordinate agencies including the Military Retirement Trust Fund, the Defense Commissary Agency, the Defense Contract Audit Agency, and the Defense Finance and Accounting Service received unqualified audit opinions on their financial statements.

The DoD Consolidated Balance Sheet is comprised of assets, liabilities, and net position. At the end of FY 2002, assets totaled \$682 billion - a decrease of \$25 billion from the \$707 billion reported in FY 2001. Fund Balance with Treasury totaled \$206 billion, and increased \$16 billion primarily as a result of additional funding for fighting terrorism throughout the world. Accounts Receivable from the public (\$6 billion) increased about \$1.7 billion due primarily to the Navy's establishment of a receivable for accrued interest related to the A-12 program, which remains in litigation.

The value of inventory and related property decreased by $59 billion from $205 billion in FY 2001 to $146 billion in FY 2002. This decrease is due to a finding by the GAO and the Department's Inspector General that early implementation in 2001 of the new military equipment accounting standard to bring missiles and uninstalled engines onto the balance sheet was the incorrect accounting treatment for those assets. Further discussion of the pending military equipment accounting standard is included below.

The Department's liabilities stayed fairly stable - rising by $32 billion from $1.42 trillion at the end of FY 2001 to $1.45 trillion at the end of FY 2002. Military Retirement Benefits liabilities of $1.3 trillion comprise the largest portion of DoD's total liabilities, with environmental liabilities of $59 billion comprising the second largest portion of DoD's liabilities. The Department's net position, which is the difference between total assets and liabilities, is a negative $770 billion due primarily to the federal accounting standard requiring the expensing of military equipment in the year it is acquired. Military equipment comprises the largest portion of DoD assets in terms of value. Net Costs of Operations in FY 2002 declined from $735 billion to $380 billion. This was due to the artificially high costs of operations reflected in the FY 2001 financial statements resulting from the implementation of legislation affecting the Military Retirement Health Benefits liability.

The Federal Accounting Standards Advisory Board made significant progress this year in developing new accounting standards for the reporting of military equipment. The accounting standard in effect since FY 1998 referred to military equipment as National Defense Property, Plant and Equipment, and required that the Department not report the value of that equipment on the balance sheet. In FY 1998, the Department wrote approximately $700 billion worth of military equipment off the Balance Sheet. The new standard for military equipment, which is awaiting final Congressional approval, requires that the acquisition costs for all military equipment be reflected on the Department's Balance Sheet, and be depreciated.

# Financial Management Issues

The Office of the Inspector General, DoD, identified thirteen material weaknesses in the FY 2001 DoD financial statement audits. While efforts are ongoing to reduce the number of material weaknesses, the Department expects that the 13 material weaknesses will continue to be reported in the FY 2002 financial statement audits. The 13 material weaknesses are:

1. DoD Financial Management Systems. The DoD-wide systemic deficiencies in financial management systems and business processes result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.

2. Intragovernmental Eliminations. The inability to reconcile most intragovernmental transactions results in adjustments that cannot be verified.

3. Accounting Entries. The Department continues to record material amounts of unsupported accounting entries.

4. Fund Balance with Treasury. A significant dollar value of disbursements is not accurately reported. Uncleared differences exist between cash transactions reported by the Department of Defense and the Treasury Department's records.

5. Problem Disbursements. Disbursements are not properly matched to specific obligations in accounting system.

6. Military Retirement Health Care Liabilities. Data quality deficiencies in the military health care system affect the accuracy of the unfunded liability.

7. Environmental Liabilities. Guidance, audit trails, and validated estimating models are insufficient. The inventory of ranges and operational activities (landfills, open burning pits, etc.) is incomplete.

8. General Property, Plant and Equipment (PP&E). The value of DoD General PP&E is not reliably reported due to lack of supporting documentation.

9. Government Furnished Material and Contractor Acquired Material. The value of DoD property and material in the possession of contractors is not reliably reported.

10. Inventory. The existing inventory valuation method does not produce an auditable approximation of historical cost because the associated gains and losses cannot be accurately tracked to specific items or purchases.

11. Operating Materials and Supplies. The Department's systems were designed to expense materials when purchased rather than when consumed.

12. Statement of Net Cost. The Statement of Net Cost is not presented by responsibility segments that align with major goals and outputs described in the Department's strategic and performance plans required by the Government Performance and Results Act. Revenues and expenses are reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.

13. Statement of Financing. The DoD cannot reconcile budgetary obligations to net cost without making adjustments.

# DoD Financial Management Improvements

During FY 2002 the Department prepared an inventory of financial and accounting systems and the associated feeder systems that provide information to financial systems. This inventory identified over 1,800 systems that support the preparation of the Department's financial statements.

During FY 2003, the Department will develop a Department-wide enterprise architecture and a transition plan. The enterprise architecture and transition plan will contain specific actions, priorities, milestones, and improvements that the Department must implement to improve the preparation of the financial statements to provide more reliable information.

# Other Progress

While an unqualified audit opinion is several years away for the Department, significant progress has been made to address some long-standing deficiencies. The Department has developed improved procedures for reconciling Fund Balance with Treasury, and has deployed a formalized training program to teach the new procedures. The Department changed its inventory valuation method to provide a true transaction-based inventory accounting. A Certified Public Accounting firm has validated the Department's methodologies for estimating environmental liabilities.

# Systems, Controls and Compliance with Laws and Regulations

## Systems

The Department is in the process of modernizing its financial management systems and improving its financial reporting processes. Today, however, many of the Department's financial management systems do not comply with federal financial management systems requirements, Generally Accepted Accounting Principles (GAAP), or the U.S. Government Standard General Ledger (USSGL).

The Department is in the process of creating a Department-wide technical design (enterprise architecture) that will prescribe how the Department's business processes will interact to ensure that all financial information is reported. This architecture will guide the development of enterprise-level business processes and systems throughout the Department that are compliant with the Federal Financial Management Improvement Act, Generally Accepted Accounting Principles, federal accounting standards, and the U.S. Government Standard General Ledger. The Department is collaborating with the Office of Management and Budget, the GAO, and the DoD Inspector General to gain their support for planned improvements to the Department's financial systems and processes.

Concurrent and consistent with the design and development of a long-term enterprise architecture, we are pursuing near-term improvements. We are refocusing existing resources on fixing problems and instituting initiatives to achieve progress in improving the Department's financial management operations.

## Controls

The Department continues to emphasize adequate checks, balances, and approval requirements for all financial transactions. Our goal is to incorporate appropriate levels of verification throughout the DoD Components without requiring excessive resources to do so, or hampering the Department's ability to complete its mission.

During FY 2002, the Comptroller focused attention on many processes and has improved financial reporting and instituted stricter internal controls. For example, DoD implemented an accounts receivable reconciliation process. As a result, the Department is collecting more accounts receivable and transferring old accounts to the Department of Treasury for collection.

Another effort focused on travel and purchase card improvements. The Department cancelled approximately 300,000 travel cards and implemented a process to collect past due amounts from cardholders. In addition, the Department implemented controls to reduce fraud and to improve validation and approval of purchase card bills.

The Defense Finance and Accounting Service (DFAS) has implemented prepayment duplicate payment detection processes for the vendor pay environment. In addition, the DFAS Internal Review office is using sophisticated duplicate detection logic and state-of-the-art automated data analysis tools to detect fraudulent and erroneous vendor payments and to provide targeted information to Internal Review teams allowing them to better focus on potential internal control weaknesses.

The Department has already seen improvements in the contractor payment process as a result of incorporating the detection logic into the contractor payment system. We now stop many potential duplicate payments before they are paid. This has resulted in a 64 percent reduction in the number of duplicate contractor payments and a 90 percent reduction in the dollar value of duplicate contractor payments over those detected during FY 2001.

In conjunction with expanded and accelerated financial statement reporting requirements, the DFAS Internal Review office identified and will implement additional techniques to improve the processes for preparing and consolidating the Department's financial statements, the associated Departmental-level journal vouchers, and the accuracy of the Department's quarterly and annual financial statements.

Through the combined efforts of the initiatives described above, the Department expects continued, marked success in strengthening internal controls.

# Compliance with Laws and Regulations

The Department of Defense is required to comply with a wide range of laws and regulations in the conduct of its daily business. The primary laws governing the preparation of the annual financial statements are the Chief Financial Officers Act (CFO Act), the Government Management Reform Act (GMRA), the Federal Managers' Financial Integrity Act (FMFIA), and the Federal Financial Management Improvement Act (FFMIA). The Office of Management and Budget has issued implementing regulations for each of these laws, which the Department has followed in preparing the financial statements. Many of the Department's systems are not compliant with federal requirements. The Department is taking aggressive action, however, to develop a financial management modernization system that incorporates standard business rules and is capable of complying with federally mandated financial reporting requirements, including federal accounting standards.

# Management Controls (Integrity Act)

# Federal Managers' Financial Integrity Act, Section 2. Material Weaknesses

Consistent with the objectives of the "Government Management Reform Act of 1994," as well as the "Reports Consolidation Act of 2000", the Department of Defense consolidated several reports required by statute into this Performance and Accountability Report. This is the first year the Department of Defense has not issued a separate report to comply with the Federal Managers' Financial Integrity Act (FMFIA). Instead, the results of the Department's evaluations under FMFIA for the period ending September 30, 2002, are included in this report.

Based on internal management evaluations, and in conjunction with the findings of the Office of the Inspector General, Department of Defense, and the Military Department Audit Agencies, the Department, except as noted in the following section, can provide reasonable assurance that it has sufficient internal controls in place to perform its assigned mission.

The management control weaknesses discussed in this section are categorized in two ways. "Systemic weaknesses" are those management control deficiencies that may affect a significant number of DoD Components and also possess the potential to have an adverse impact on the Department's overall operations. The Department's eight systemic weaknesses, including corrective action plans, are discussed in depth in the following pages.

Taken together, "material weaknesses" are those management control problems that primarily pertain to a single DoD Component and do not have as serious an impact on the performance of the entire Department. Material weaknesses are reported at the end of this section. As a whole, a total of 70 material weaknesses remain uncorrected as of September 30, 2002. Those material weaknesses are concentrated in the financial and acquisition management areas, and are being addressed by senior management.

The Department increased its efforts to resolve all material weaknesses in a timely fashion through a renewed emphasis on a rigorous management control program. Review of each DoD Component's implementation of its management control program began in 2002 and will be completed in 2003. The Department is placing special emphasis on correcting internal control problems identified through audits or internal reviews that remain uncorrected after three years, and is placing highest priority on strengthening controls that will prevent potential fraud, waste and abuse of government resources.

# FY 2002 DoD Systemic Weaknesses

## *Financial Management Systems and Processes*

Department of Defense financial management systems and business processes do not provide information that is accurate, reliable and timely, thus hindering effective management decision-making. The current financial environment is comprised of many discrete systems characterized by poor integration and minimal data standardization. This absence of an overarching approach to financial management has resulted in a consistent failure by the Department to pass financial audits.

### *Impact*

An inferior financial management information infrastructure hinders the efficiency and effectiveness of the Department's operations and prevents managers from making more timely and cost-effective decisions. The Department's substandard financial management processes and information infrastructure, and the absence of a Department-wide, integrated approach to financial management, also contribute to the following difficulties:

- Overly complex data requirements that are driven by appropriation funding rules, elaborate policies and procedures, and outdated guidelines for excessively detailed tracking of expenditures.
- Convoluted business processes that fail to streamline excessive process steps that are further complicated by aged and disparate systems (accounting, financial and nonfinancial ("feeder")).
- Inability to meet evolving federal financial management standards.
- Difficulty in obtaining financially based, outcome-oriented, metrics for decisionmakers. Many of the metrics currently in use reflect weak links between annual performance goals and outputs.
- Inability to produce annual financial statements that result in an unqualified audit opinion.
- Personnel who lack the technical skills necessary to support and maintain integrated financial management systems and operations.

### *Management Response*

The Department is improving its financial management processes, systems, and information by engaging in a number of wide-ranging initiatives:.

- The Secretary of Defense established the Financial Management Modernization Program to direct and oversee financial management reform within the Department. A new directorate within the Office of the Under Secretary of Defense (Comptroller) was created to lead the reform effort. Its main task is to develop a financial management enterprise architecture. That architecture will serve as a blueprint for a coordinated DoD-wide management approach to improving business processes and implementing integrated financial management systems.
- In April 2002 the Department awarded a major contract for development of the Department-wide financial management enterprise architecture.
- The Under Secretary of Defense (Comptroller) has created a review process utilizing strict criteria to manage and control all investments in DoD financial management systems.

*Planned Actions*

- Complete development of the financial management enterprise architecture and transition plan by April 2003.
- Reengineer the Department's financially related business processes to ensure routine availability of reliable, accurate and timely financial management information.
- Develop a capital investment strategy and investment plan that includes costs, people, policies, processes and systems for the Department's transition to a fully integrated financial management system that is compliant with applicable federal and DoD standards.
- Fashion an information architecture that supports shared financial management data across the Department, with the following characteristics:
    - Collects data by specific project, business line or weapon system life cycle cost, that will allow DoD managers to compare financial management and cost management information with the Department's performance goals.
    - Incorporates an architectural and transition plan that guides the development and deployment of new financial management capabilities, with a concurrent reduction in the costs of such development.
    - Incorporates the goals of the Government Paperwork Elimination Act.
    - Includes all current and planned financial management systems and the financial portions of DoD business systems, including any business systems in which the transactional effects of financial events are recorded.

# *Environmental Liability*

At the request of the House Committee on the Budget, the GAO conducted an audit of the Department's progress in estimating the potential long-term budgetary implications associated with environmental clean-up costs related to the "ongoing operations" of the Department. Ongoing operations are those day-to-day operations that may require cleanup activities if or when those operations are shut down. Examples include landfills, underground storage tanks, and hazardous waste storage facilities. The GAO determined that the Department has not yet developed the policies, procedures, and methods needed to ensure that cleanup costs (environmental liabilities) for all of its ongoing and inactive or closed operations are identified, consistently estimated, and appropriately reported. Prior audit reports examined the data supporting the environmental liabilities entry on the DoD Agency-wide Financial Statements and addressed problems in five main areas:

- Clarification, expansion, and implementation of guidance;
- Standardization and verification, validation, and accreditation of the methods used to estimate "cost-to-complete;"
- Completion of DoD range inventories;
- Adequacy of audit trails for cost-to-complete systems; and
- Adequacy and accuracy of data calls.

## *Impact*

The Department's financial statements and environmental reports under-report environmental liabilities and understate the Department's related long-term budgetary requirements for cleanup activities.

## *Management Response*

Efforts during the past year have focused on providing guidance that will help the DoD Components to compile complete, accurate, and fully substantiated environmental liability data. The Department is placing emphasis on recognizing what constitutes a reportable environmental liability, how such a liability should be measured, and when and where it should be recorded. Commercial sector accounting guidance is being used to the maximum degree feasible. Among its efforts to provide clearer guidance, the Department has:

- Published revisions to the Department of Defense Financial Management Regulation ("DoDFMR") on September 2002 that provide guidance on when to record a liability.
- Published updated Defense Environmental Restoration Program (DERP) management guidance on September 28, 2001. That guidance addressed: (1) the identification, investigation, research and development, and cleanup of contamination from

hazardous substances, and pollutants and contaminants; (2) correction of other environmental damage (such as the detection and disposal of unexploded ordnance) which creates an imminent and substantial endangerment to the public health or welfare, or to the environment; and (3) demolition and removal of unsafe buildings and structures, including buildings and structures of the Department of Defense at sites formerly used by, or under the jurisdiction of, the Secretary of Defense.

- Validated the Remedial Action Cost Engineering and Requirements (RACER) cost estimating model (July 11, 2001) and Navy cost-to-complete cost estimating model (October 18, 2001) used in the calculation and documentation of environmental liability costs.

In addition:

- DoD Components are developing and maintaining adequate supporting documentation and audit trails for their DERP cost-to-complete estimates. Estimated completion date is September 30, 2004.
- DoD Components are developing the required inventory of nonoperational range sites. Estimated completion date is September 30, 2004.
- The DoD Inspector General is in the process of validating the Army's cost estimating methodology for the chemical weapons disposal liability. Estimated completion date is March 30, 2004.
- The Navy asserted in its Management Representation Letter that it has a sound methodology for estimating liabilities associated with nuclear powered ships and submarines. The Navy's liability estimating methodology will be assessed by the DoD Inspector General to determine its accuracy and completeness.

### *Planned Actions*

- The Department also plans to publish additional guidance to enable DoD installation personnel to determine when the potential exists for an environmental liability for on-going operations. If there is an environmental liability, the guidance will standardize how estimates are developed and categorized. The target completion date is May 2003.
- DoD Components will develop an inventory of non-DERP activities (on-going operations) by August 2004.
- Beginning in FY 2003, the Office of the Under Secretary of Defense (Acquisition, Technology and Logistics) (OUSD(AT&L)) will assess progress made by the Department in reporting complete, accurate, and supported environmental liability data in the FY 2002 DoD financial statements.

# *Munitions and Explosives*

In 1999, the Department of Defense identified a material weakness in the management of munitions and explosives at operational test and training range complexes, and on munitions response areas (formerly used areas that are no longer on operational ranges). Ensuring sustainable use of operational ranges for training is essential to the Department's ability to fulfill its mission--now and in the future. Increasing urban encroachment, along with regulatory and public interest pressures, threaten continued use of operational ranges. To protect human health and safety, more intense management of unexploded ordnance and munitions on operational ranges is required. For munitions response areas, the Department is required to respond to unexploded ordnance (and buried and abandoned munitions), in a manner that protects human health and the environment. Furthermore, the General Accounting Office has determined that the Department's training range cleanup cost estimates are understated, and identified the need for accurate inventories and cost methodologies to substantiate the related financial liabilities accurately.

## *Impact*

The Department's financial statements and environmental reports do not adequately identify financial liabilities caused by munitions use. As a result, the Department's related long-term budgetary requirements to manage unexploded ordnance adequately and to respond to munitions related problems are potentially understated.

## *Management Response*

The Department is developing management procedures to address munitions and explosives issues on both operational ranges and munitions response areas. To date, the Department has:

- Validated the RACER cost estimating model used to calculate and document environmental liability costs (July 11, 2001).
- Updated the DERP management guidance to include policy for munitions response activities funded by the DERP accounts (September 28, 2001).
- Established a Sustainable Defense Readiness and Ranges Integrated Process Team to address operational test and training range management (December 2001).
- Approved the Munitions Action Plan (MAP) developed by the Operational and Environmental Executive Steering Committee for Munitions. The MAP serves as a "roadmap" for action across the entire life cycle of munitions (March 2002).
- Provided guidance to the DoD Components to determine financial liabilities and identify budget requirements for environmental management tasks on operational ranges and appropriate remedial actions for munitions response areas (September 2002).

### *Planned Actions*

- The OUSD(AT&L) will publish additional guidance to enable DoD personnel to manage munitions response, operational range management, disposal of range residue, and to determine when the potential exists for a munitions-related environmental liability. The guidance will standardize how environmental liability cost estimates are developed and categorized. The target completion date is May 2003.
- DoD Components will develop an inventory of operational ranges and munitions response sites by April 2004.
- Beginning in FY 2003, the OUSD(AT&L) will assess progress achieved by the Department in reporting complete, accurate, and supported munitions-related environmental liability data during the review of the fiscal year 2002 and future year financial statements.

## *Contracting for Services*

Numerous DoD Inspector General reports identified various pre- and post-contract award issues that are not being adequately addressed for the procurement of services within the Department.

### *Impact*

Lack of adequate acquisition oversight to ensure that appropriate planning and procedures are being followed may result in less than optimal utilization of resources when contracting for DoD services. Unlike the acquisition of major systems, service contracts do not always receive the same degree of rigorous review prior to contract award and during contract execution. The growing size and complexity of DoD service contracts makes it imperative that greater discipline be applied to the review of those procurements. The most direct potential impact of lax oversight is failure to obtain the best value on individual procurements, specifically when all of the available competitive pricing opportunities are not properly considered.

### *Management Response*

In FY 2002, the Under Secretary of Defense for Acquisition, Technology and Logistics (USD(AT&L)) has issued new DoD-wide policy governing the management and oversight of the acquisition of services. An acquisition strategy must now be developed and approved for each acquisition of services, and funding actions as well as business arrangements must be executed in accordance with that approved strategy. Metrics for cost, schedule and performance also must be established for each service acquisition.

Those metrics will then be forwarded to the appropriate Decision Authority to assess execution progress.

*Planned Actions*

The Department plans a number of future corrective actions. Among them, the OUSD(AT&L) will:

- Review DoD Component implementation of the new policy governing oversight of service contracts by March 2003.
- Revise the Defense Federal Acquisition Regulation Supplement (DFARS) to implement Section 803 of the FY 2002 Defense Authorization Act (Public Law 107-107), which requires competition in the purchase of services greater than $100,000 under multiple award contracts. The final rule will be published in 2003.
- Increase awareness of service contracting issues and oversight procedures through a variety of acquisition training forums, including the 2003 Department of Defense Procurement Conference.

# *Government Card Program Management*

## Purchase Cards

Audit reports have provided evidence of failures of the internal control systems designed to mitigate the risk of abuse or misuse of government charge cards within the Department. The audits revealed instances of misuse, abuse, and fraud that were caused by inadequate DoD activity level emphasis on proper use of the purchase card, poorly enforced controls and lax oversight.

*Impact*

Lack of DoD activity level emphasis and failure to implement management controls fully produces an environment that increases the risks of charge card abuse, misuse and fraud. Lax enforcement of management controls removes the oversight necessary to ensure the cost-effective and appropriate use of charge cards. As a result, cardholders may at times procure items that are not required for mission support, or that are intended for personal use. Failure of management controls also undermines the ability of the Government to seek adjustments for billing errors or fraudulent purchases that were not made by the cardholder. In addition, the failure of management controls could result in the government not obtaining the best possible price.

### *Management Response*

The Deputy Secretary of Defense issued a memorandum to all DoD Components on June 21, 2002, emphasizing the requirement to maintain appropriate stewardship of taxpayer dollars when using the government purchase card. The OUSD(AT&L) is developing an overarching directive governing purchase card roles and responsibilities within the Department. Specific improvements in management controls during FY 2002 include the following actions by the OUSD(AT&L):

- Established a method to ensure that purchase cards are collected from all departing civilians and military members prior to separation.
- Prepared and disseminated throughout the Department, guidelines for the implementation, maintenance and oversight of the purchase card program. This effort included a thorough review of those policies and regulations intended to establish effective management controls for the program.
- Completed a field test of an enhanced, centralized data mining tool to assist in the detection of fraudulent, wasteful and abusive purchase card transactions.

### *Planned Actions*

Future corrective actions planned by the OUSD(AT&L) include:

- Develop and field enhanced training materials for cardholders and their responsible oversight officials. This is an ongoing activity.
- Accelerate the use of on-line billing statement review, approval and certification by the second quarter of FY 2003.
- Increase awareness of proper purchase card use through a variety of existing training forums, including a session of the 2003 DoD Procurement Conference.

## Travel Cards

The principal problem with the DoD Individually Billed Account (IBA) travel charge card program is the misuse and late payment or non-payment by military members and civilian personnel of travel charge card debt owed to the bank. Under the General Services Administration contract with the travel charge card contractor, cardholders are required to pay the total balance on their account within 30 days of the end of the billing cycle to keep the account current. In addition, cardholders do not have to pay interest on outstanding balances.

The General Services Administration standard delinquency rate is calculated on balances unpaid after 60 days. Using this measure, the Department's performance during the first three years of the program has been poor, with monthly delinquency rates as high as 25 percent. Performance has been progressively improving, but the rates during FY 2001 and the first two quarters of FY 2002 were 50 to 90 percent higher than the average of other federal agencies.

The travel charge card contractor is required by banking laws to write-off the overdue balance when an account is delinquent more than 210 days. Delinquent travel card payments have been largely corrected by the introduction of salary offset in October 2001. Previously, the bank's only recourse was to attempt recovery through private debt collection. With salary offset, the contractor can request that the government recover the debt from the individual's pay. Bank write-off levels have fallen from a high of $2.5 million in February 2001 to less than $500,000 (generally between $100,000 and $200,000) per month during FY 2002.

There are also documented instances of inappropriate use of travel charge cards. Travel charge cards are to be used only for expenses incurred in connection with official government travel. Unofficial use subjects the travel charge card contract to greater risk of delinquent payments and write-offs because the inappropriate charges will not be reimbursed to the cardholder by the government.

### *Impact*

High delinquency rates and excessive write-offs have two important consequences. First, they threaten the Department's contractual relationship with the travel charge card contractor. Since the contractor cannot charge interest on outstanding balances, and since the late payment fee is charged at a later point than on a consumer credit card, the contractor's cost of funds will be higher than anticipated. While this is of primary concern to the card-issuing bank, it also could be problematic to the Department in future competitive solicitations for card services resulting in possible increased fees to cardholders and costs to the Department to reimburse the fees.

### *Management Response*

In April 2001, a contract modification was approved to encourage DoD members to pay their travel charge card bills in a more timely manner and reduce the financial risk of the travel charge card contractor. The Under Secretary of Defense (Comptroller) (USD(C)) issued a memorandum that month which implemented policy changes resulting from the contract modification. These changes included:

- Increased fees charged by the contractor for automated teller machine withdrawals, late payments and returned checks.
- Salary offset for delinquent amounts beginning in October 2001.
- A 50 percent reduction in travel charge card credit limits.
- A reduction in the number of active cards issued to infrequent travelers. From November – December 2001 the DoD Components reviewed cards held by infrequent

travelers (those making two or fewer trips in a year). This resulted in the cancellation of 115,000 cards and the deactivation of 112,000 cards.

In March 2002, the USD(C) established a Charge Card Task Force to investigate program improvements to both the purchase card and travel card programs. The Task Force was comprised of representatives from the Military Departments and requested input from the General Services Administration (GSA), Office of Personnel Management (OPM) and Department of Justice. The USD(C) released the DoD Charge Card Task Force Report on June 27, 2002. Recommendations of the Task Force that have been implemented include:

- Cancellation of over 300,000 inactive travel charge card accounts.
- The tasking of the Service Secretaries and Component Heads to review their travel and purchase card programs and report on actions being taken to reduce delinquencies and address misuse.
- The development of metrics related to charge cards which are being reported to senior management on a regular basis, including measures of delinquent dollars, delinquent accounts (both number of accounts and the aging of the delinquencies), accounts sent for salary offset, and accounts written off by the bank.

During this same time frame, the USD(C) issued guidance redefining mission critical status to require specific supervisory approval on the travel authorization in circumstances where an individual cannot submit travel vouchers and make timely payments because of the travel. Mission critical status delays suspension of cards for non-payment and allows reimbursement for late fees. The revised definition prevents misuse of mission critical status to postpone payment of charge card bills.

The Department also proposed legislation, which was enacted by section 1008 of the Bob Stump National Defense Authorization Act for Fiscal Year 2003. That legislation authorizes the Department to send payments to the issuer of the travel card for official travel or transportation expenses charged on the Defense travel card by a Department of Defense employee or member (commonly referred to as "split disbursement.") Split disbursement was previously authorized only at the option of the employee or member. In addition to providing for salary offsets of current military personnel and civilian employees, section 1008 also authorizes salary offset of military and civilian retiree pay. The new legislation should result in reduction to the Department's travel charge card delinquency rates and the amount of uncollectible debt. This legislation will be implemented through changes to the "Department of Defense Financial Management Regulation."

*Planned Actions*

Further action continues on the following Charge Card Task Force recommendations:

- The Military Departments and Defense Agencies will ensure that supervisors and security managers are informed of allegations of travel card misuse and abuse so that an appropriate determination can be made regarding suspension of security clearances.

The OUSD(AT&L) will:

- Develop an overarching directive on travel card roles and responsibilities within the Department by March 31, 2003.
- Produce a compact disk for distribution to Agency Program Coordinators that contains basic information about the travel card program, including individual liability and responsibility as well as those of the commander/supervisor. The compact disk is not intended as a complete cardholder training program, but will provide links to additional training sites. The target completion date is February 28, 2003.
- Develop methods to ensure government purchase and travel cards are collected and canceled from all departing civilians and military members. The Defense Manpower Data Center is currently working on a match of separations, deceased and retired employees to active card accounts so that card managers can be notified to cancel those accounts. (This action is complete as of January 2003).

The OUSD(AT&L), in conjunction with the Military Departments and Defense Agencies, will:

- Develop a centralized data-mining tool to detect travel charge card abuse and misuse by June 2003.
- Develop enhanced card program metrics for senior management oversight. (This action was completed in December 2002.)
- Investigate travel voucher processes to identify improvements to reduce the time required to obtain reimbursement by December 2003.
- Implement an exemption from mandatory use of card for travel incident to certain deployments/missions that are likely to result in untimely settlement of travel vouchers by March 2003.
- Revise compliance sections of regulations to clarify procedures to be utilized for travel charge card misuse and abuse; and increase awareness of training material available from the travel charge card contractor and the GSA by March 2003.

# *Information Assurance*

The Office of the Assistant Secretary of Defense (Command, Control, Communications and Intelligence) (OASD(C3I)) has determined that the Department's information systems are potentially vulnerable to an information warfare attack. The Department has uncovered numerous attempts to breach "sensitive but unclassified" systems and networks supporting finance, logistics, medical, procurement, personnel and research and development activities. The widespread use of sophisticated viruses and more sophisticated "distributed denial of service" attacks will continue to challenge the Department. Assessments by OASD(C3I) and audits by the DoD Inspector General continue to show that security certification and accreditation of individual information and computing systems and applications within the Department is not adequate. Failure to comply with accreditation requirements, or maintain this accreditation, leaves many systems vulnerable to attack or exploitation.

## *Impact*

A successful attack on DoD systems would have a serious and immediate impact on the ability of the DoD to carry out its mission.

## *Management Response*

The OASD(C3I):

- Issued a DoD directive in January 2001 and a DoD instruction in March 2001 establishing policy, responsibilities and organization for computer network defense.
- Assigned a military lead (currently United States Space Command) for Computer Network Defense within the Department in September 1999.
- Removed information from the Department's websites that may have revealed operational capabilities or vulnerabilities in March 1999.
- Implemented the Information Assurance Vulnerability Alert (IAVA) process to alert units to security vulnerabilities and to manage their correction in March 2001.
- Subjected all DoD business processes to robust functional process improvements to include the information assurance that will provide needed system protections. Mandated purchase of only commercial information assurance products approved by the National Information Assurance Partnership or the National Security Agency for national security systems effective in July 2002.
- Is deploying electronic tokens to secure access among all DoD system users and organizations and issued secure electronic authentication certificates (to validate user identity) to all DoD users so that electronic mail is protected by digital signature. (This action is ongoing.)

- Published information assurance readiness metrics and reporting policy to continually assess the readiness posture of DoD Components in March 2000.
- Established the Information Assurance Scholarship Program in June 2001 to provide increased professional education and training opportunities for DoD personnel as well as improving the Department's ability to recruit trained information assurance professionals directly from college.
- Established a connection approval process for classified and unclassified networks to validate the security of sub-networks as a condition of connection in August 1999.

*Planned Actions*

The OASD(C3I) will:

- Complete revision of overarching information assurance policy by the first quarter 2003.
- Revise DoD security certification and accreditation policy and process to improve compliance and provide enterprise management capability by September 2003.
- Complete deployment of DoD Public Key Infrastructure and issue of electronic tokens (via the Common Access Card) to entire DoD population by October 2003.
- Complete enterprise-wide certification standards for information assurance/ technology professionals to raise and continuously improve existing skills by May 2003.
- Develop an information assurance/technology workforce management capability to identify and track personnel performing that function. This capability also may be used to ensure that those professionals are suitably trained and certified. The target completion date for the Civilian Personnel Data System improvements is June 2003, and for military databases, June 2004.
- Develop an enterprise-wide strategy to infuse, and continually enhance, information assurance awareness and training into programs for all end users by June 2004.
- Deploy commercial software security product(s) designed to eliminate vulnerabilities introduced through standard default installations by September 2003.

## *Personnel Security Investigations Program*

Personnel security investigations within the Department have not been conducted in a timely manner over the past several years. While timeliness is improving for new cases received after March 2002, the overall average investigative periods still do not meet required national standards. These investigations determine whether an individual should be granted access to classified information; accessed or retained in military service; or employed in a sensitive position.

*Impact*

The thoroughness and timeliness of personnel security investigations directly affects Department operations and is a matter of national security.

*Management Response*

Since 1999, the Defense Security Service (DSS) has implemented changes and enhancements to both hardware and software that significantly improved the Case Control Management System (CCMS) throughput, capabilities, and response time for both internal and non-DoD customers. These changes enabled DSS to close over 583,000 personnel security investigations in FY 2001, a 43 percent gain in productivity over FY 2000. Other actions taken by DSS in 2002 include the following:

- Created the Office of Standards and Evaluation and Quality Management to evaluate the performance of Investigators, Case Analysts, and the written products they prepare.
- Published and disseminated a new Personnel Security Investigations Manual that provided much greater clarity concerning the required standards and procedures to use when conducting investigations.
- Reduced to approximately one percent the number of closed investigations returned to DSS due to inadequacies in investigative coverage, and reduced the total error rate to four percent (returned investigations and those corrected by the DoD central adjudicative facilities).

*Planned Actions*

DSS continues to establish new, improved methods to project workload and to ensure surges in requirements caused by unforeseen events such as the September 11, 2001, terrorist attack can be handled through implementation of a more agile workforce and increased support system automation. In 2003, the Department will reengineer the business processes to define more efficient, effective processes and methods to improve the speed and quality of the personnel security clearance process.

## *Management of Real Property (Facilities)*

The Department lacks a long-range plan to address obsolescence and deterioration of its facilities and has related management deficiencies with the Family Housing program, which supports military members and their families. Proper disposal, maintenance, upgrade, and replacement of DoD facilities is essential to the performance of the Department's mission, and is a key component of military and civilian morale.

*Impact*

Failure to use a rigorous, analytically supported, criteria-based approach to support DoD infrastructure resource requirements results in less than optimal decisions about facility acquisition, sustainment, recapitalization, and retention. Obsolete and excess facility infrastructure drains scarce resources from other facility requirements and creates potentially non-supportable future year unfunded liabilities. Acquisition of new facilities in the absence of adequate sustainment and recapitalization funding for existing facilities compounds the problem because it increases the cost to maintain the total inventory of DoD facilities.

*Management Response*

The Office of the Deputy Under Secretary of Defense (Installations and Environment)::

- Published the Defense Facilities Strategic Plan in August 2001.
- Created two new performance measures (Facilities Sustainment Model (June 2000) and Facilities Recapitalization Metric (August 2002)) and established performance targets for both in the May 2002 Defense Planning Guidance.
- Increased funding by $2 billion in FY 2002 to begin reducing the estimated $62 billion restoration of facilities requirement. The increased funding permitted the Military Departments to accelerate facilities restoration efforts and make progress toward the goal of achieving a C-2 level of facilities readiness by FY 2010. A C-2 level of facilities readiness is one in which the facility is free of deficiencies that affect the performance of its intended function, or that may negatively affect mission accomplishment.
- Improved the FY 2002 facilities recapitalization rate to 101 years (vice 192 years), set a recapitalization rate goal of 67 years by FY 2007, and reassessed methodologies for computing recapitalization rates.
- Increased the FY 2003 facilities sustainment budget to 93 percent of commercial benchmarks (vice 89 percent in FY 2002) and established a goal of full sustainment levels by FY 2004.
- Initiated development of a common, Department-wide, Real Property Enterprise System that will accurately account for and track financial information (such as depreciation) necessary to improve decisions related to future real property investments.
- Neared completion of a draft policy for housing requirements process. The proposed policy will standardize and streamline the process used by the Military Departments to calculate housing requirements, which focuses on private sector solutions first. Final policy will be submitted to the Deputy Secretary of Defense for approval in FY 2003.

*Planned Actions*

The Office of the Deputy Under Secretary of Defense (Installations and Environment) will:

- Continue ongoing demolition programs to eliminate excess facilities and initiate a round of Base Realignment and Closure.
- Complete a revised DoD directive ("DoD Housing Management"), revise the DoD Housing Manual, and promulgate specific guidance for the housing requirements policy addressed above in FY 2003.
- Conduct a comprehensive review of facilities sustainment, restoration, and modernization programs planned for the FY 2004-2009 period. (The review was completed in October 2002, and related decisions were included in the December 2002 Program Decision Memorandum.)
- Develop advanced tools for managing investments designed to return facilities to C-2 status by approximately FY 2010.

# FY 2002 DoD Material Weaknesses

## *FMFIA Section 2 Material Weaknesses*

**(As of September 30, 2002)**

| Year Reported | Number Reported | Number Corrected | Pending Correction |
|---|---|---|---|
| FY 1998 and Prior | 915 | 897 | 18 |
| FY 1999 | 20 | 12 | 8 |
| FY 2000 | 18 | 10 | 8 |
| FY 2001 | 41 | 27 | 14 |
| FY 2002 | 36 | 14 | 22 |
| Total | 1,030 | 960 | 70 |

The table above displays the status of all DoD material weaknesses by fiscal year, as well as the progress achieved in correcting those weaknesses.

In previous reports, the Department listed all of the material weaknesses reported by the individual DoD Components regardless of whether those weaknesses were fundamentally similar in nature, were deemed material to the Department as a whole, or were already addressed under the corrective actions planned for the eight DoD-wide systemic weaknesses. The numbers in the above table reflect improved analysis and greater accuracy as to the actual status of management controls and corrective efforts within the Department.

Of the 1,030 weaknesses, 960 (93 percent) have been corrected. In FY 2002, the Department reported 25 new weaknesses, corrected a total of 44 weaknesses, and consolidated the reporting of 26 additional material weaknesses. Details on the material weaknesses consolidated appear in the table below. Of the remaining 70 weaknesses, 69 percent were identified in the prior years, and 31 percent were newly identified. The FY 2001 Department of Defense Statement of Assurance report identified 115 uncorrected material weaknesses. During FY 2002 the Department experienced a net decrease of 45 uncorrected weaknesses, for a 39 percent reduction in the total number of uncorrected weaknesses.

## *Material Weaknesses Consolidated in FY 2002*

| Year Reported | Number Consolidated |
|---|---|
| FY 1998 and Prior | (3) |
| FY 1999 | (5) |
| FY 2000 | (3) |
| FY 2001 | (7) |
| FY 2002 | (8) |
| Total | (26) |

# Federal Managers' Financial Integrity Act, Section 4. Financial Management Systems

Most of the Department of Defense's critical financial management systems do not comply with the requirements of the Federal Financial Management Improvement Act as described in Office of Management and Budget Bulletin No. 01-02. The deficiencies associated with these systems will be addressed during the development of the financial management enterprise architecture described in Part II of this report. The architecture's transition plan will prescribe specific remedies to correct systems' deficiencies. Consequently, specific remedial actions will not be discussed in this report.