Fiscal Year 2001

Department of Defense

Overview

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Transforming Financial Management in the Department of Defense

The Department of Defense (DoD) has successfully demonstrated the power of joint operations in combat. The overwhelming force demonstrated in the Gulf War, and again in Kosovo and Operating Enduring Freedom, relied on cutting-edge technologies in synchronized tactics, interoperable systems, and fully integrated communication channels to maximize the substantial independent capabilities of the Army, the Navy, the Air Force, and the Marines. Similarly, the Department intends to leverage technology, streamline processes, and integrate logistical and personnel support systems with its financial systems to improve the Department's efficiency and save money.

The major management challenges in strategic planning, human capital, information technology, acquisition, contract management, support infrastructure, and logistics all require timely, accurate, and reliable financial information for decisionmaking. Therefore, the Secretary has launched a Department-wide financial management reform program that affects every policy, process, and system. Success will be measured by maximizing returns on taxpayer investment, and by freeing up resources for weapon system modernization and readiness.

Senior Leadership, Direction and Guidance

The responsibility for achieving results rests squarely on the Department's senior leadership. The Secretary advised the Secretaries of the Military Departments and the Directors of the Defense Agencies that they are accountable to the Secretary for the results of their business operations and financial management systems. In addition, the Secretary has commissioned teams of business experts and new management boards to provide guidance and leadership.

"Friedman" Study. At the Secretary's direction, the Department commissioned a study to develop recommendations for financial management improvements. Stephen Friedman, chairman of the Columbia University board of trustees, chaired the study that identified key deficiencies and recommended actions to strengthen and transform the Department's financial management processes. The final report, *"Transforming Department of Defense Financial Management: A Strategy for Change,"* dated April 13, 2001, provided the foundation for many of the changes that are taking place within the Department today.

Defense Business Practices Implementation Board. The Secretary recently established this Advisory Board to the Department's Senior Executive Council to provide strategies to adopt best business practices in management, finance, acquisition, production, personnel, and logistics. The Under Secretary of Defense (Comptroller) will capitalize on the experience of these private sector senior executives and business leaders to optimize the Department's financial management transformation.

Financial Management Modernization Program. On July 19, 2001, the Secretary established a Department-wide program to transform the systems and processes that produce or use financial information--including those associated with supply management, personnel, acquisition, and health care. Central to the Financial Management Modernization Program is the development of an integrated financial management system. The Department is well on the way toward this goal. The technical foundation for transformation of these processes and systems will be complete by March 2003. Known as an "Enterprise Architecture" and recognized as a best practice, this effort will define the interaction of the Department's financial and nonfinancial functional systems and management processes.

The Secretary established the Financial Management Modernization Executive Committee to provide sufficient high-level leadership. A Steering Group meets weekly under the direction of the Under Secretary of Defense (Comptroller) in coordination with the Under Secretary of Defense for Acquisition, Technology and Logistics and the Chief Information Officer, to oversee and to provide policy direction for the execution of all financial management reform efforts. A Program Management Office, reporting to the Comptroller, has begun developing the financial management technical design. That office will develop specific guidance for the use of standard accounting data, for the reform of financial systems and business processes, and for the interaction of nonfinancial systems and business processes.

DoD Objectives for Sound Financial Management

The Department has determined, through consultation with external experts and benchmarking studies, that development of an integrated Department-wide financial management structure and system is key to the management improvement efforts. The system shall have core elements in order to produce the results as follows:

Core elements
- Standard accounting elements
- Robust internal controls at critical points in the flow of data
- Standard methods of performing accounting and budgetary transactions
- Clear identification of costs
- Standard business processes
- Central control and management of financial systems and processes.

Results
- Comparable financial and cost accounting information for management
- Better management from the application of reliable and usable financial data
- Simplified capital investment process
- Verifiable audit trails

- Clean audit opinions on the Department's financial statements.

Financial Management Progress in FY 2001

In FY 2001, the Department made substantial progress addressing financial management deficiencies, much remains to be done and we are moving "full speed ahead."

As important as a clean audit opinion is, it is not the Department's only goal. Just as important is the availability of timely, accurate, and reliable information for decisionmaking. In order to gain the maximum benefit from our improvement efforts, we are concentrating on fixing the problems at their source--rather than correcting bad data after-the-fact. Analysis of financial management processes is continuing to identify these root causes of financial recording and reporting deficiencies, as well as the fixes required.

Several near-term initiatives are underway that concentrate on improving the accuracy and timeliness of the Department's financial management information. We are tracking our performance using detailed metrics and applying additional emphasis to areas where the results are less than expected. Where needed, we have and will continue to implement revised or expanded financial management policies to capture and accurately report financial management information. These policies address requirements that begin at the inception of an event or transaction and follow through to its ultimate recording and reporting in our financial management systems.

Progress during FY 2001 is identified below. Copies of significant documents demonstrating the Department's commitment to progress are included in the Appendix to this Overview.

ASSETS

Fund Balance with Treasury

- Problem: Fund Balance with Treasury remains unreliable due to unreconciled statement of differences and unidentified disbursements and collections posted to suspense accounts.

  Accomplishments:
  - ✓ The Defense Finance and Accounting Service (DFAS) Denver Center improved reconciliation processes, procedures, and personnel training. As a result, the undistributed differences of Air Force general fund transactions were reduced from $26 million in 1998 to approximately $348 thousand in 2001.
  - ✓ A standard Fund Balance with Treasury reconciliation training course was developed and, during FY 2002, it is being deployed to all of the DFAS Centers.
  - ✓ Action is underway to implement the required Fund Balance with Treasury reconciliation requirements. This change will reduce the unreconciled balances.

Inventory and Operating Materials and Supplies

- Problem: Amounts reported in this category have not included all inventory and operating materials and supplies (OM&S) and the valuation method did not result in auditable values.

  Accomplishments:
  - ✓ Increased the completeness of OM&S reporting by $69 billion. This represented the value of missiles and other subcomponents, previously treated as National Defense Property, Plant and Equipment (ND PP&E) and not reported on the Balance Sheet.
  - ✓ Changed the Department's inventory valuation method to moving average historical cost. This policy change once fully implemented will result in transaction based accounting for inventory.

General Property, Plant and Equipment

- Problem: General property, plant and equipment (PP&E) and related assets have not been fully and accurately reported in the Department's financial statements.

  Accomplishments:
  - ✓ Successfully presented the case to the Federal Accounting Standards Advisory Board (FASAB) for a revised accounting treatment for Military end items (such as aircraft, ships and tracked vehicles). The result is the FASAB is preparing an exposure draft, which is expected to support the DoD position. If adopted as expected in the exposure draft, the result will be full reporting of DoD's military end items on the Balance Sheet. The Department anticipates the increase in General PP&E will be in the hundreds of billions of dollars.
  - ✓ Reorganized the management of the Defense Property Accountability System (DPAS) to improve its support to more than 13,000 users world-wide. Also, established a Data Quality Assurance function; set up a central, state-of-the-art, call center (Help Desk); and expanded training. The DPAS system is used by the Army, Navy, Marine Corps, and most Defense Agencies.
  - ✓ To improve financial control and reporting of property, developed a comprehensive property accountability directive and manual, to be issued in March 2002. The directive and manual consolidate separate policies contained in memorandums and regulations, as well as industry best practices, into a single DoD-wide mandatory policy issuance.
  - ✓ For government furnished property, identified the root cause problem as inconsistent requirements between the Federal Acquisition Regulation (FAR) and generally accepted accounting principles (GAAP). To resolve this, DoD has prepared a proposed revision to the FAR, Part 45 and is working with the Office of Management and Budget and industry to finalize the proposal. This revision is expected to result in improved asset visibility, management and financial reporting of government furnished property.

LIABILITIES

Military Retirement Health Care Benefits Liability

- Problem: Improvements are needed in the scope and accuracy of the actual cost data used as the basis for the actuarial calculation of military retirement health care benefits liability.

  Accomplishments:
  - ✓ The Department has identified applicable cost data needed to accurately calculate the military retirement health care benefits liability.
  - ✓ The Department is working with the General Accounting Office (GAO) and the Department's Office of Inspector General to ensure that all applicable costs are identified.
  - ✓ Implemented a management control program for the data systems in the direct care system and all Military Treatment Facilities now have data quality managers performing monthly reviews of data quality.

Environmental Liabilities

- Problem: The DoD's financial statements and environmental reports continue to under-report environmental liabilities.

  Accomplishments:
  - ✓ The Department's methodology for calculating environmental liabilities related to nuclear ships has been validated by the audit community.
  - ✓ Validated the Remedial Action Cost Engineering and Requirements (RACER) model, that is used for estimating environmental liabilities. The validated model provides audit trail documentation for the liability estimate and will be used Department-wide.

OTHER FINANCIAL MANAGEMENT INITIATIVES

In addition, to specific balance sheet categories, the Department is making improvements in other financial management areas.

Disbursements Not Properly Matched to Specific Obligations

- Problem: Disbursements that are not properly matched to specific obligations recorded in the DoD's record continue to impede efforts to improve its budgetary data. The root cause of the problem stems from insufficient documentation or inaccurate data necessary to properly match disbursements to specific obligations recorded in the accounting records. Such disbursements can remain unresolved for long periods of time.

Accomplishments:
- ✓ To improve the Department's performance in this area, a new policy was issued in January 2001 directing the DoD Components to record obligations for disbursements over 180 days old that have not been posted against a valid obligation. This policy change has resulted in a $432 million decrease in the value of disbursements over 180 days old that have not been recorded against a valid obligation.
- ✓ In order to continue the progress made in FY 2001, action is underway to revise the criterion for determining when a disbursement must be posted to a valid obligation. Effective April 2002, the criterion is being reduced from 180 days to 120 days.
- ✓ The Department implemented the Defense Cash Accountability System (DCAS) at several of its finance and accounting offices. The DCAS system facilitates the electronic submission of accounting data vice hardcopy voucher documentation. This will decrease the possibilities of missing documentation or inaccurate data. The DCAS system is expected to be deployed to other locations during FY 2002.
- ✓ Implemented the Standard Contract Reconciliation Tool to compare the Mechanization of Contract Administration Services system entitlement data to the accounting system data. This comparison aligns payment data to accounting data and aids in the resolution of questionable disbursements and facilitates contract reconciliation.

Accounting for Canceled Appropriations

- Problem: During a FY 2001 audit of the contract pay and reconciliation systems at the DFAS Columbus Center, the GAO identified 162 adjustments (over $615 million) to canceled appropriations that appeared to be either illegal, improper, or containing insufficient documentation to sustain the adjustment.

  Accomplishments:
  - ✓ The DFAS Center has reversed 124 of the reported adjustments and provided documentation to the GAO for the remaining 38. To prevent future recurrence, DFAS implemented appropriate systems and procedural changes. Also, canceled funds adjustments have been added to the Management Control Review program.
  - ✓ Revised the performance standards for technicians, accountants, and supervisors to include an element pertaining to canceled funds adjustments.

Human Capital

- Problem: The Department needs to improve the skills of its financial management workforce and improve succession planning.

- Problem: The Department needs to improve the skills of its financial management workforce and improve succession planning.
  Accomplishments:
  - ✓ Conducted a preliminary review of the financial management (FM) workforce to gather data on the size and composition of the FM workforce in August 2001.
  - ✓ Developing a roadmap for strengthening the FM workforce by developing strategies for enhancing technical competencies, motivating employees to pursue advanced degrees and professional certifications, reinvigorating recruitment and retention. The report is scheduled to be completed March 31, 2002, and briefed to the Comptroller.

Financial Statements

The DoD financial statements for FY 2001 have been prepared to report the financial position and results of operations for the entity, pursuant to the requirements of the "Chief Financial Officers Act of 1990" and the "Government Management Reform Act of 1994."

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 financial management systems limitations. The Department continues to implement system improvements to address these limitations. There are other instances when the Department's application of the accounting standards is different from the auditors' application of the standards. In those situations, the Department has reviewed the intent of the standard and applied it in a manner that management believes fulfills that intent.

The statements, which are prepared from the books and records of the Department in accordance with the formats prescribed by the Office of Management and Budget, supplement the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation that provides resources to do so.

Assets

Total assets on the Agency-wide Consolidated Balance Sheet amount to over $707 billion. This represents an increase of more than $90 billion over the amount reported in the FY 2000 statements. The largest contributor to the increase is in Inventory and Related Property. As discussed in Note 9, the increase resulted from reclassifying some items formerly considered as ND PP&E (not included on the Department's balance sheet) to Operating Materials and Supplies (a category of Inventory and Related Property). These items consist primarily of tactical missiles and missile motors, aircraft configuration pods, and uninstalled aircraft engines.

Liabilities
Total liabilities on the Agency-wide Consolidated Balance Sheet amount to over $1.4 trillion--a $400 billion increase over liabilities reported in the FY 2000 financial statements. The major portion of this increase is due to the effect of Public Law 106-398, which extended medical benefits to military retirees and their beneficiaries who are eligible for Medicare. Previously, military retirees and their beneficiaries were moved from the military medical treatment plan to Medicare when they reached age 65.

Net Cost
The net cost of operations increased by $410 billion over FY 2000. The $388 billion increase in Military Retirement Health Benefits is the major contributor to that increase. Costs for FY 2001 include all costs necessary to establish the initial estimated liability resulting from the new legislation. Costs for future years will include only the annual incremental costs of the program, and thus should be significantly less than the costs reported on these financial statements.

National Defense Property, Plant and Equipment
The Department is supporting the Federal Accounting Standards Advisory Board (FASAB) in its efforts to revise the accounting treatment for Military end items (such as aircraft, ships and tracked vehicles). The FASAB is preparing an exposure draft, which is expected to support the DoD position. If adopted as expected in the exposure draft, the result will be full reporting of DoD's military end items on the Balance Sheet.

In the meantime, given the current lack of systems to support the requirement, the Department is suspending the reporting of ND PP&E information until such time as the FASAB adopts permanent reporting requirements.

Financial Management Systems, Controls and Legal Compliance

The Department is committed to effective internal controls and full compliance with established systems guidelines and standards, as well as proper stewardship of the resources entrusted to it.

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, and the U.S. Government Standard General Ledger at the transaction level, and did not do so as of September 30, 2001.

The Department is unable to fully comply with applicable reporting requirements for:
(1) property, plant and equipment; (2) inventory and operating materials and supplies;
(3) Military Retirement Health Care actuarial liability; (4) environmental liabilities;
(5) intragovernmental eliminations and related accounting adjustments; and (6) cost accounting by suborganization or responsibility segment and major program.

The Department is in the process of creating a Department-wide technical design (enterprise architecture) that will prescribe how the Department's financial and nonfinancial feeder systems and management processes will interact. This architecture will guide the development of compliant enterprise-level processes and systems throughout the Department. The Department is collaborating with the Office of Management and Budget, the GAO, and the Office of the Inspector General, DoD, to gain insight and support for our planned improvements to the Department's financial systems and processes.

Concurrently with the long-term enterprise architecture development effort, we are pursuing near-term improvements, as previously discussed, consistent with the design of the longer-term systems solutions. 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's "Annual Statement of Assurance" describes the systemic weaknesses recognized by the Department, including actions taken and initiatives planned and underway.

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 all of the DoD Components without requiring excessive resources or hampering the Department's ability to complete its mission.

A DoD-wide internal control initiative, "Operation Mongoose," completed its sixth year as DoD's financial management fraud prevention and detection program. This program utilizes state-of-the-art technology to detect and prevent fraudulent and erroneous payments.

The Defense Finance and Accounting Service is utilizing sophisticated duplicate detection logic and state-of-the-art data mining technology to provide targeted information to Internal Review teams allowing them to better focus in on potential internal control weaknesses. An Internal Review of contract reconciliation procedures resulted in naming a new Reconciliation Contract Manager, and additional training in contract management and funding laws for personnel at all levels in the contract reconciliation process. Additionally, two systems changes to the contract payment system were implemented during FY 2001 to resolve internal control weaknesses reported as a result of the Internal Review.

Through the combined efforts of the initiatives described above, the DoD financial management community expects continued, marked success in strengthening internal controls.

Legal Compliance

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, the Government Management Reform Act, the Federal Managers' Financial Integrity Act, and the Federal Financial Management Improvement Act. The Office of Management and Budget has issued implementing regulations for each of these laws, which the Department has followed in preparing these Financial Statements. As noted above in the "Systems Compliance" section, many of the Department's systems are not compliant with federal requirements. The Department is taking aggressive action, however, to develop and implement financial and nonfinancial feeder systems capable of complying with federally mandated requirements, including federal accounting standards.

Snapshot of the Department

Our Mission

The Department's primary mission is to provide the military forces needed to deter war and protect the security and national interests of the United States.

Our Resources

The Department of Defense is the nation's largest employer, with 1.4 million men and women currently on active duty, 687,000 civilians, and another 869,000 volunteers serving in the Reserve Components as of September 30, 2001. We have a world-wide presence with military and civilian personnel located in more than 130 countries, in every time zone and every climate.

The Department maintains a robust infrastructure in order to support its force structure. No other U.S. firm owns, operates, and maintains a comparable volume of physical assets (property, plant and equipment, and inventories).

Our personnel are located at approximately 600 fixed facilities, composed of more than 40,000 properties that occupy roughly 18 million acres of land. The Department operates and maintains approximately 250,000 vehicles, over 15,000 aircraft, more than 1,000 oceangoing vessels, and some 550 public utility systems.

America's oldest, largest and most diverse "firm" operates with resources in a manner comparable to private industry. Our annual budget in FY 2001 was approximately $315 billion.

Our Organizational Structure

Orders for military operations emanate from the President and the Secretary of Defense. The President, as Commander in Chief of the Armed Forces, is the ultimate authority. The Office of the Secretary of Defense carries out the Secretary's policies by tasking the Military Departments, the Chairman of the Joint Chiefs of Staff and the Unified Combatant Commands. 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 Unified Combatant Commands. The Defense Agencies and DoD Field Activities perform selected consolidated support and service functions on a Department-wide basis.

Joint Chiefs of Staff

Representatives from all the Military Services support the Chairman of the Joint Chiefs of Staff in his capacity as the principal military advisor to the President, the National Security Council and the Secretary of Defense. The Joint Chiefs of Staff command structure consists of the Chairman, the Vice Chairman, and the four-star heads of the four Military Services. The Chairman plans and coordinates military operations involving U.S. Armed Forces and, as such, is responsible for the operation of the National Military Command Center. He meets regularly with the four Service chiefs to resolve issues and coordinate "joint" Service military activities.

Commanders in Chief

The Secretary of Defense uses the military command structure to deploy troops and exercise military power. This authority is directed, with the advice of the Chairman of the Joint Chiefs of Staff, to his nine combatant commanders-in-chief (commonly referred to as "CINCs"). The CINCs have direct links both to the President and Secretary of Defense. Five CINCs have geographical responsibility, while the remaining four have world-wide responsibility.

The Military Departments

Troops are trained and equipped through our three Military Departments--the Army, the Navy and the Air Force. The Marine Corps, our main amphibious force, is a component of the Department of the Navy.

Army
The Army's mission is to defend the land mass of the United States and its territories, commonwealths and possessions, and overcome any aggressor that imperils our nation's peace and security.

Throughout history, wars have been won primarily by armed forces on the ground. Only soldiers on the ground can take and hold territory. America's Army effectively deploys its forces and establishes direct, continuous, and comprehensive control over land, resources, and people to achieve victory on the battlefield and ensure peace.

Additionally, the Army's Corps of Engineers Civil Works Program develops, manages, protects, and enhances our nation's water and related land resources for commercial navigation, flood damage reduction, environmental restoration, and allied purposes. The Civil Works Program diligently supports the Army in peacetime pursuits, during national emergencies, and in times of war.

Navy
The U.S. Navy is America's forward deployed force and a major deterrent to aggression around the world. Our aircraft carriers are stationed in hot spots around the globe--in the Far East, in the Persian Gulf, and in the Mediterranean Sea--ready to provide a quick response to any crisis world-wide.

The Navy maintains, trains and equips combat-ready Naval forces capable of winning wars, deterring aggression, and maintaining freedom of the seas.

Marine Corps
The call "Send in the Marines!" has been sounded more than 200 times since the end of World War II, an average of once every 90 days.

The Marine Corps provides sea-based, integrated air-ground units for contingency and combat operations, and for suppressing or containing international disturbances.

Air Force
The Air Force defends the United States through control and exploitation of air and space, and provides America a rapid, flexible, and when necessary, lethal air and space capability. It can deliver forces anywhere in the world in less than 48 hours. It routinely participates in peacekeeping, humanitarian, and aeromedical evacuation missions. Air Force crews annually fly missions into almost all of the nations of the world.

Reserve Components
Our active military forces are supported by the world's premier military power multiplier--forces of the Reserve Components, including the Army and Air National Guard and the Army, Navy, Marine Corps, and Air Force Reserves. Within the last decade, 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. These personnel comprise approximately half of America's total uniformed force.

Defense Agencies and DoD Field Activities

Title 10 U.S.C. provides that: "Whenever the Secretary of Defense determines such action would be more effective, economical, or efficient, the Secretary may provide for the performance of a supply or service activity that is common to more than one military department by a single agency of the Department of Defense." Although Defense Agencies and DoD Field Activities perform similar support functions, in general, DoD Field Activities are smaller and serve a more limited portion of the Department than Defense Agencies. The ability to combine common services and supplies has proven beneficial in reducing redundancy among the military departments and conserving scarce resources through centralized management. There are currently 15 Defense Agencies and 7 DoD Field Activities.

Performance Goals, Objectives, and Results

The Department's performance goals, objectives, and results are documented in the annual performance plans as required by the "Government Performance and Results Act of 1993." The Department's performance plan for FY 2001 will be submitted to the Office of Management and Budget in the Spring of 2002.

Summary

The Financial Management Modernization Program marks a turning point in the Department's efforts to achieve timely, accurate, and reliable information. While much remains to be done, the Department is aggressively attacking the challenges it faces in transforming its financial management processes and systems, and made significant progress during FY 2001. The Secretary has put in place the needed leadership, accountability, and structure to ensure that progress continues.

Appendix

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

JUL 6 2001

MEMORANDUM FOR DEPUTY UNDER SECRETARY OF DEFENSE FOR LOGISTICS AND MATERIEL READINESS
ASSISTANT SECRETARY OF DEFENSE (HEALTH AFFAIRS)
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT AND COMPTROLLER)
SENIOR CIVILIAN OFFICIAL, OFFICE OF THE ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE ARMY FOR ACQUISITION, LOGISTICS AND TECHNOLOGY
ASSISTANT SECRETARY OF THE NAVY (RESEARCH, DEVELOPMENT AND ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE (ACQUISITION)

SUBJECT: Approved Valuation Method for Inventory Held for Sale and Operating Materials and Supplies

The Department of Defense legacy systems were not designed to maintain historical cost valuation for inventory held for sale and operating materials and supplies in compliance with generally accepted accounting principles. Despite significant efforts to achieve an auditable financial presentation using available data, the current approach, latest acquisition cost adjusted for holding gains and losses, does not provide meaningful financial accounting information and has failed to gain audit acceptance.

The use of the moving average cost inventory valuation method should provide the best value to the Department, based on the Components' analyses of the Department's material management policies and processes. The Department of Defense Financial Management Regulation, DoD 7000.14-R, Volumes 4 and 11B, will be modified to establish moving average cost as the Department's standard valuation method for the financial statement presentation of inventory and operating materials and supplies. The Military Departments and the Defense Agencies may request exceptions to this valuation method for their financial statements from the Director, Accounting Policy. Each Military Department and Defense Agency responsible for material amounts of inventory or operating materials and supplies shall implement the moving average cost valuation method as systems are renovated or replaced. Alternative valuation methods may continue to be used for other functional requirements (e.g., logistics, procurement, and budget) as deemed necessary by the cognizant functional managers. Such methods include the use of the latest acquisition cost and standard price.

This policy is effective upon receipt of this memorandum. The point of contact for this matter is Gretchen Anderson. She may be reached by e-mail: andersog@osd.pentagon.mil or by telephone at (703) 697-4691 (DSN 227-4691).

Nelson Toye
Deputy Chief Financial Officer

THE SECRETARY OF DEFENSE
1000 DEFENSE PENTAGON
WASHINGTON, DC 20301-1000

JUL 19 2001

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
CHAIRMAN OF THE JOINT CHIEFS OF STAFF
UNDER SECRETARIES OF DEFENSE
DIRECTOR, DEFENSE RESEARCH AND ENGINEERING
ASSISTANT SECRETARIES OF DEFENSE
GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE
DIRECTOR, OPERATIONAL TEST AND EVALUATION
DIRECTOR, ADMINISTRATION AND MANAGEMENT
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES

SUBJECT: Financial Management Information within the Department of Defense

One of my highest priorities is to have reliable, accurate and timely financial management information upon which to make the most effective business decisions. Because we do not always have that information, we must change the Department's business operations and systems.

The Department's business activities include financial and nonfinancial operations and systems. Nonfinancial business operations and systems include those that support the acquisition, medical, transportation, property, inventory, supply, and personnel communities, as well as other communities. Currently, the Department's financial and nonfinancial operations and systems do not work effectively together to produce the most desirable financial management information. Correcting this deficiency is everyone's responsibility.

Toward this end, I hereby establish a Department-wide Financial Management Modernization Program and direct the following:

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- The Under Secretary of Defense (Comptroller), in coordination with the Under Secretary of Defense for Acquisition, Technology and Logistics and the Chief Information Officer, shall provide policy direction and oversee the execution of all Financial Management Modernization Program efforts.

- A Program Management Office shall be established and shall report to the Under Secretary of Defense (Comptroller). The Program Management Office shall develop a DoD-wide blueprint--an Enterprise Architecture that is consistent with the Department of Defense Chief Information Officer's Information Technology architecture--that prescribes how the Department's financial and nonfinancial feeder systems and business processes will interact. The Program Management Office also shall be responsible within the Defense Acquisition System for control and oversight of systems development, acquisition, upgrade, deployment, and other changes for all financial management systems and related nonfinancial business systems, to include legacy systems. In addition, the Program Management Office shall perform such other Department-wide Financial Management Modernization Program-related efforts as may be directed by the Under Secretary of Defense (Comptroller), in coordination with the Under Secretary of Defense for Acquisition, Technology and Logistics and the Chief Information Officer.

- The Secretaries of the Military Departments and the Directors of the Defense Agencies shall be accountable to me for the results of their Component's business operations and financial management systems. The Under Secretary of Defense (Comptroller) is responsible for ensuring we meet the objectives of this memorandum and for the overall direction of our financial management reforms.

Modernizing our business operations and systems is a Department-wide priority, and will need leadership at every level. The Under Secretary of Defense (Comptroller) is available as needed to help Components, Services, and Defense Agencies in this effort.

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

AUG 21 2001

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
CHAIRMAN OF THE JOINT CHIEFS OF STAFF
UNDER SECRETARIES OF DEFENSE
DIRECTOR, DEFENSE RESEARCH AND ENGINEERING
ASSISTANT SECRETARIES OF DEFENSE
GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE
DIRECTOR, OPERATIONAL TEST AND EVALUATION
ASSISTANTS TO THE SECRETARY OF DEFENSE
DIRECTOR, ADMINISTRATION AND MANAGEMENT
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DEPARTMENT OF DEFENSE FIELD ACTIVITIES

SUBJECT: Deployment of Financial Management Enterprise Resource Planning (ERP) Systems

The Secretary of Defense recently established the Financial Management Modernization Program to provide policy direction and oversight for the execution of all financial management modernization efforts. While investments in Enterprise Resource Planning (ERP) systems are important, their overall impact on the Department's pending Financial Management Enterprise Architecture must be assessed. Therefore, all Department Components may continue their current Enterprise Resource Planning initiatives up to and including the point of completion of the pilot/prototype evaluation. The results of a third party assessment must be presented in a formal brief to the Under Secretary of Defense (Comptroller). Under no circumstance should any initiative request approval to enter production nor be deployed--without the explicit written concurrence of the Under Secretary of Defense (Comptroller). The requirements addressed above are in addition to, and not in lieu of, any other defense acquisition policy and Clinger-Cohen Act certification requirements.

My point of contact for this action is Ms. Catherine Santana. She may be reached by e-mail: santanac@osd.pentagon.mil or by telephone at (703) 692-5000.

Dov S. Zakheim

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

OCT 12 2001

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
CHAIRMAN OF THE JOINT CHIEFS OF STAFF
UNDER SECRETARIES OF DEFENSE
DIRECTOR, DEFENSE RESEARCH AND ENGINEERING
ASSISTANT SECRETARIES OF DEFENSE
GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE
DIRECTOR, OPERATIONAL TEST AND EVALUATION
ASSISTANTS TO THE SECRETARY OF DEFENSE
DIRECTOR, ADMINISTRATION AND MANAGEMENT
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DEPARTMENT OF DEFENSE FIELD ACTIVITIES

SUBJECT: Defense Financial Management Modernization Program – System Initiatives

The Secretary of Defense recently established the Financial Management Modernization Program to provide policy direction and oversight for all financial management modernization efforts. While prudent investments in operational, developmental, and new system initiatives are important to maintain and improve the Department's business operations, the overall impact on the Department's pending financial management enterprise architecture must first be assessed. Therefore, until the architecture is developed to guide our modernization efforts, all DoD Components must control their financial system and related non-financial (feeder) system investments as described below.

For currently operational systems, a DoD Component Head may approve and fund changes that address priority 1 or 2 core mission issues only. This approval should reflect coordination from both the Component's financial management senior proponent and Chief Information Officer (CIO). System changes to satisfy a financial compliance requirement alone should not be considered a priority 1 or 2 issue. Any system change that does not meet this criteria may not be funded or implemented without my prior written approval.

Issue prioritization is defined by the Institute of Electrical and Electronics Engineers (IEEE) 12207.2, "Standard for Information Technology—Software Life Cycle Processes." A priority 1 problem is one which would (a) prevent the accomplishment of an essential capability, or (b) jeopardize safety, security, or other requirement designated "critical." A priority 2 problem is one which would (a) adversely affect the accomplishment of an essential capability and no work-around solution is known, or (b) adversely affect technical, cost, or schedule risks to the project or to life cycle support of the system, and no work-around solution is known.

Systems currently under development may be continued up to, and including, completion of the pilot/prototype evaluation at which point the results of an independent third-party assessment must be presented to me in a formal brief. Under no circumstance should Components allow any system initiative to enter into production or be deployed without my written concurrence.

New system initiatives (initiatives which have not received a Milestone A decision prior to the release of this memorandum), regardless of their investment threshold, must complete the following pre-Milestone A requirements: Business Process Review and Improvement, Mission Need Statement and Trade-off Studies. The results of these efforts must be presented to me in a formal brief. Under no circumstance should a DoD Component request approval for any new initiative to enter Milestone A without my written concurrence.

This guidance is effective immediately and remains in effect until the Financial Management Enterprise Architecture is developed and follow-on guidance released. All system investment approval requests and related documentation must be sent to the Office of the Under Secretary of Defense (Comptroller), Financial Management Modernization Task Force, Pentagon Room 3A731, Washington, DC 20301-1100.

The requirements addressed above are in addition to, and not in lieu of, any other defense acquisition policy and Clinger-Cohen Act certification requirements. My point of contact for this action is Ms. Catherine Santana. She may be reached at (703) 692-5001, or by e-mail at santanac@osd.pentagon.mil.

Dov S. Zakheim

OFFICE OF THE SECRETARY OF DEFENSE

1000 DEFENSE PENTAGON
WASHINGTON, DC 20301-1000

0 3 DEC 2001

Mr. David Mosso
Chairman
Federal Accounting Standards
Advisory Board
Washington, DC 20548

Dear Mr. Mosso:

The Secretary of Defense made financial management modernization one of the Department's highest priorities with the goal of making reliable, accurate and timely financial information readily available to decision makers. This includes information on the Department's mission essential assets--military equipment. In addition, the Secretary desires to manage the Department in more of a business-like manner. Therefore, the Department supports the intent of the Federal Accounting Standards Advisory Board's Exposure Draft, titled "Accounting for National Defense Property, Plant and Equipment and Associated Cleanup Costs," to capitalize and depreciate the costs of military equipment.

As indicated in the specific comments contained in the enclosure, the Department of Defense strongly recommends that the accounting treatment and reporting requirements for military equipment be the same as those for other federal agencies' mission essential assets. Accordingly, we recommend that the Federal Accounting Standards Advisory Board modify the Statement of Federal Accounting Standards No. 6, "Accounting for Property, Plant and Equipment," to include military equipment in the accounting and reporting requirements for General Property, Plant and Equipment and formally recognize the use of composite depreciation.

We recognize and regret that the Board has struggled for many years with the accounting treatment for the Department's military equipment, but we are certain that the Board will agree that our recommendation is the "right thing to do" for the Department of Defense and the federal government.

E. C. Aldridge, Jr.
Under Secretary of Defense
(Acquisition, Technology and Logistics)

Dov S. Zakheim
Under Secretary of Defense
(Comptroller)

Enclosure

FEDERAL RECYCLING PROGRAM PRINTED ON RECYCLED PAPER

DEPARTMENT OF DEFENSE
COMMENTS ON THE
FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD
EXPOSURE DRAFT
"ACCOUNTING FOR NATIONAL DEFENSE PP&E
AND ASSOCIATED CLEANUP COSTS"

GENERAL COMMENTS

This paper provides Department of Defense (DoD) comments and recommended changes to the proposed accounting and reporting requirements contained in the Exposure Draft titled, "Accounting for National Defense PP&E and Associated Cleanup Costs," dated August 31, 2001.

The primary objective of the Federal Accounting Standards Advisory Board (FASAB), when developing the accounting requirements in the Exposure Draft, was to issue an accounting standard that requires the DoD to capture the cost of military equipment and to capitalize such costs. The accounting requirements contained in the Exposure Draft result in an accounting treatment that is basically the same accounting treatment required for General Property, Plant and Equipment (GPP&E) in Statement of Federal Financial Accounting Standards (SFFAS) No. 6, "Accounting for Property, Plant and Equipment"--except for the absence of a requirement to depreciate Major End Items.

After careful consideration of the proposed requirements, the DoD recommends that the FASAB modify SFFAS No. 6 to include military equipment in the definition of GPP&E, as well as to make additional modifications that explicitly recognize the acceptability of the use of composite depreciation. The recommendation to modify SFFAS No. 6 to address military equipment is the basis for many of the specific comments that follow.

SPECIFIC COMMENTS

Exposure Draft Requirement: *Use of the term and definition of "National Defense Property, Plant and Equipment" (ND PP&E) and two categories of ND PP&E: "Major End Items" and "Mission Support Items."*

DoD Response: Other than a very small group of DoD individuals familiar with the efforts of the FASAB to develop an accounting standard for military equipment, the terms ND PP&E, Major End Items and Mission Support Items are unknown. Within the Department, such PP&E is referred to as military equipment. The DoD objects to the introduction of new terminology that serves no useful purpose, would confuse DoD personnel and could cause significant difficulty in implementing and sustaining the proposed accounting requirements.

DoD Recommendation: Modify SFFAS No. 6 to include military equipment within the accounting requirements for General PP&E. The term "military equipment," when incorporated in SFFAS No. 6, need not be defined by the FASAB, since the accounting treatment for military

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equipment would be the same as it is for General PP&E. If military equipment was explicitly defined by the FASAB, unnecessary detailed analyses would be required to determine what was to be categorized as military equipment, rather than GPP&E. Such extensive classification efforts would serve no useful purpose. Additionally, the classification of military equipment could vary by Military Service based on each Military Service's use of such equipment. When implementing the accounting requirements for military equipment, the Department needs the flexibility of a less prescriptive standard.

Exposure Draft Requirement: *Capture the cost of Major End Item acquisition programs and write off the cost of such programs as items are destroyed or taken out of service.*

DoD Response: As the DoD modernizes its financial management processes and systems, the Department plans to capture the full cost, in accordance with SFFAS No. 6, of acquiring and modernizing military equipment by type of equipment and to allocate such costs to benefiting periods in a systematic and rational way using composite depreciation.

DoD Recommendation: Modify SFFAS No. 6 to explicitly recognize the acceptability of using composite depreciation.

Exposure Draft Requirements: *Reporting of quantity and condition information for Major End Items, (cost to date, current year cost, projected costs, quantities delivered, quantities to be delivered, etc) for the 10 largest ND PP&E acquisition programs and reporting of Program Management Office (PMO) costs.*

DoD Response: The Department believes that the reporting requirements specified in SFFAS No. 6 for General PP&E, including Balance Sheet presentation and depreciation, should apply to military equipment and that the imposition of any additional requirements, beyond those that apply to every other entity of the federal government, is inappropriate and unnecessary. Furthermore, with regard to the requirement to report information on the 10 largest ND PP&E acquisition programs, the Department also opposes this requirement for the following additional reasons: (1) reporting such information is not required of any other federal agencies, (2) this information is already available in greater detail to DoD and congressional decision makers, (3) reporting such information in annual financial statements will be inconsistent with information provided to the Congress in the DoD budget because of timing differences, and (4) this type of information is not typically presented in financial statements of government or private entities.

DoD Recommendation: Delete the requirements.

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