I'm offering these comments as background information for DBB members who may be particularly interested in the agenda topic, "DoD Audit and Incremental Progress," that USD(C) Mike McCord will be presenting on February 6th.

I'm assuming most if not all of the DBB members who will be participating know that the Department's pursuit of private-sector-style financial statements (i.e., balance sheets and income statements) tailored to government operations has been going on for more than 40 years, going back to the time of the passage of the CFO Act of 1990. I'm assuming they are also aware of the long-running criticism the Department has been subject to regarding the continuing difficulties and setbacks it has experienced in its pursuit of unqualified auditor opinions for those statements.

With that as background, my intent is to provide DBB members access to my 15-page paper, "Financial Accountability at the DoD: Reviewing the Bidding," published in the July 2009 issue of the Defense Acquisition Review Journal, accessible online at: https://apps.dtic.mil/sti/tr/pdf/ADA597938.pdf (pages 181-196).

The paper describes the historical background underlying the passage of the CFO Act and its requirement that Executive Branch agencies (including the DoD) begin producing financial statements subject to audit. It makes the case for the idea that the production of such statements has never made sense for the DoD and, while well-meaning, is only making the pursuit of improved financial decision-making in the Department more difficult than it needs to be.

So that you and DBB members know, I will note that the Defense Acquisition Review Journal (now called the Defense Acquisition Research Journal) is a peer-reviewed practitioner journal published by the Defense Acquisition University (DAU) - and that my paper is cited in both Peter Levine's 2020 book, Defense Management Reform - How to Make the Pentagon Work Better and Cost Less and in the new (2nd edition, 2024) of Philip Candreva's book, National Defense Budgeting and Financial Management - Policy and Practice.

Best regards,

-Christopher Hanks
(Retired, LMI 1980-1993; RAND 1993-2006; IDA 2006-2008)

FINANCIAL ACCOUNTABILITY AT THE DoD: REVIEWING THE BIDDING

Christopher H. Hanks

However beautiful the strategy, you should occasionally look at the results.

Winston Churchill

The Chief Financial Officers (CFO) Act of 1990 requires the DoD to produce private sector-style financial statements that can win unqualified opinions from auditors. After many years of effort to comply, the department is now projecting that its balance sheets will not be ready until 2017 and is unable to predict when its income statements will be ready. Given that discouraging situation, combined with the increasingly widespread realization that external financial statements are of no practical use for internal management, the question arises whether it makes sense for the DoD to continue its pursuit of "CFO compliance." A review of the history of the CFO strategy suggests the DoD needs to shift its efforts to the development of managerial cost accounting—not private sector-style financial accounting—if progress is to be made.

Keywords: *Accounting, Accrual-based Accounting, Budgetary Accounting, Business Transformation, Business Transformation Agency, CFO Act, CFO Compliance, Clinger-Cohen Act, Cost Accounting, Enterprise Architecture, Financial Accountability, Financial Management, Financial Statements, Government Management Reform Act (GMRA), Managerial Cost Accounting, Matching Principle, Strategic Leadership, Working Capital Fund*

Image designed by Harambee Dennis »

(CFO)

Chief Financial Officers Act of 1990

The theory underlying the Chief Financial Officers (CFO) Act of 1990 and related legislation, including the Government Management Reform Act (GMRA) of 1994, the Federal *Financial Management* Improvement Act (FFMIA) of 1996, and the *Clinger-Cohen Act* of 1996, is that if federal agencies are required to develop and use a financial *accounting* and reporting system similar to the one used in the private sector—i.e., one that produces private sector-style *financial statements* (balance sheets and income statements)—agency operations will become more effective and efficient over time. A key assumption is that private sector-style accounting and reporting will provide information beyond what traditional *budgetary accounting*[1] provides that decision makers and managers will be able to use to improve performance.

Although this article focuses on the DoD, the *CFO Act* (and related legislation) applies not just to the DoD but to all executive agencies in the federal government. The infrastructure that has grown up to control and direct the implementation of the CFO strategy across the entire government is described in Steinhoff (2005).

Three years after the CFO Act was passed, its "measure and report" approach would be reinforced by the National Performance Review (NPR) initiated by the Clinton administration in 1993. The NPR and the associated Defense Performance Review were grounded in the "new public management" theories that emerged in the 1990s calling for greater use of market mechanisms in the public sector (Osborne & Gaebler, 1992; Thompson & Jones, 1994). Although the NPR addressed more than financial management, it nevertheless increased the pressure on executive branch agencies, including the DoD, to step up *CFO compliance* efforts. Given that financial accounting is a proven measurement and reporting system, together with the traditional inclination at the DoD to view support activities as "business operations,"[2] it was perhaps inevitable that DoD leaders would embrace the CFO strategy in the 1990s and commit the department to the achievement of "CFO compliance"—i.e., the ability to produce auditable private sector-style financial statements for all of the department's activities—no matter how difficult that might prove to be.

THE CHALLENGES OF CFO COMPLIANCE

As things have turned out, it has proven to be very difficult. Indeed, despite almost 20 years of substantial effort and expense on the department's part[3], CFO compliance has not been achieved and remains beyond the department's reach. The department's latest Financial Improvement and Audit Readiness Plan, for example, projects that the required CFO balance sheets will not be "audit ready" before 2017 and makes no projections at all about when the required income statements[4] will be ready beyond that point (DoD, 2009).[5]

WILL THE EFFORT BE WORTH IT?

One lesson the last 20 years has taught is that few decision makers in government pay any attention to the CFO financial statements. In a recent report on the results of its 12th annual "CFO Survey" of 239 federal financial-management executives and managers, the Association of Government Accountants observes that "few people actually read federal financial statements, much less use them for making decisions." To explain why that's the case, the report notes that almost all of the 120 senior executives interviewed—representing 70 departments, departmental agencies, and independent entities and commissions—expressed the view that "very little of the information in federal financial reports (in their current private sector-based form) is relevant to government decision making." That view, by the way, has nothing to do with whether the financial reports received unqualified auditor opinions or not. As one survey respondent put it when asked about the financial statements his agency had produced that had received unqualified opinions: "We're getting A's on our tests but not learning anything" (Association of Government Accountants, 2008).

Given the above situation, it is not unreasonable for the DoD to start trying to find a new way. The defenders of the CFO strategy, however, continue to believe that the strategy is sound and that the difficulties DoD has experienced represent a failing of the department rather than a failing of the strategy. To counter that view, it is necessary to dig more deeply into the origins of the CFO strategy and confront the arguments that have been made in its defense more directly.

ONE LESSON THE LAST 20 YEARS HAS TAUGHT IS THAT FEW DECISION MAKERS IN GOVERNMENT PAY ANY ATTENTION TO THE CFO FINANCIAL STATEMENTS.

THE ORIGINS OF THE CFO STRATEGY

The CFO strategy has its origins in work of Professor Robert N. Anthony (1916–2006) of the Harvard Business School. A specialist in the fields of accounting and management control, Anthony was a member of the HBS faculty for more than 40 years. His direct involvement with the Department of Defense came in 1965 when a former HBS accounting colleague, Robert S. McNamara, asked him to come to Washington to help establish a financial-management and accounting system that support the DoD's new Planning, Programming, and Budgeting System (PPBS) (McCaffery & Jones, 2004; Jones & McCaffery, 2005). Taking up Secretary McNamara's offer, Anthony went to Washington and served as the DoD Comptroller for 3 years, from 1965 to 1968.

The perspective that Anthony brought to his Pentagon assignment—an accountant's perspective that lies at the heart of the CFO strategy—is that if the executives and managers running the Department of Defense are to succeed at improving the department's effectiveness and efficiency over time and make sound resourcing decisions, the department's accounting system should give them the same kind of information that business executives and managers need to know whether their businesses are operating profitably or not. For all but the simplest of commercial businesses (which can use cash accounting), such information is obtained by using an "*accrual-based accounting* system." Accrual-based accounting is based on the idea that the only way to reliably determine whether a business is operating profitably or not (which is what owners, investors, and managers ultimately care about) is to record and match revenues with expenses on the books when those revenues and expenses are realized in interactions with customers, regardless of when cash is received or paid. A business that produces and sells widgets, for example, will spend money to produce widgets that it will hold in inventory before they are sold. Under accrual accounting, even though cash may have been paid out when the widgets were being made, the widgets will not be "expensed" on the books until they are sold (delivered) to customers. When that happens (i.e., when a sale takes place), a revenue entry (the amount the customer has promised to pay) and an expense entry (the "cost of goods sold") will be made, and the two entries become matched. The private sector's experience has shown that if the foregoing realization and *matching principle* of accrual accounting is followed, the information on properly assembled financial statements will provide a reliable basis for determining whether a business is operating profitably or not over time.[6]

In thinking about how accrual-based financial accounting could be done to improve DoD management, however, Anthony faced a fundamental definitional problem. As noted above, the purpose of accrual-based financial accounting is to determine whether a business is operating profitably or not—but the DoD is not a business trying to make profits. Rather, it is a publicly funded government activity that was created and exists to produce national security. Finding a way to define the DoD's outputs, revenues, and expenses so that accrual-based accounting can be done, therefore, is not as straightforward as defining those things for a commercial business, where outputs, revenues, and expenses (namely products, sales, and costs) are usually easier to define. Hanks (2008) further discusses problems associated with viewing DoD activities as "businesses."

To deal with the definitional problem, Anthony proposed that as many DoD support activities as possible (all of its central logistics activities, for example) should be placed under revolving-fund financing (Thompson & Jones, 1994; Shycoff, 1995).[7] Revolving-fund financing (now referred to as working-capital-fund financing) creates buyer-seller relationships between support activities and the military forces (mission activities), who are the customers. Revolving-fund support activities sell goods and services to mission activities that pay for the goods and services they receive with appropriated funds (usually Operations & Maintenance appropriations). The proceeds of the sales are then used to replenish the underlying revolving funds so the support activities can keep on operating.

From Anthony's accounting perspective, the advantage of the revolving-fund arrangements is that the financial-transaction data they generate make it possible, as required by the matching principle of accrual accounting, to expense the goods and services used to produce national security at (or near) the time that national security is "sold" (i.e., delivered) to the country and its citizens (Anthony, 1962, 1996, and 2000).[8]

THE CFO STRATEGY REQUIRES A SYSTEM-WIDE APPROACH

Anthony's idea also requires that the new accounting system cover everything the DoD does, not just its revolving-fund support activities. Recognizing this fact when he was the Comptroller (1965–1968), Anthony proposed a broad reform program to establish accrual accounting for the entire department, called Project Prime. If it had been put in place (it was not), Project Prime would have reclassified every activity in the DoD as either a "mission activity" or a "support activity"—with all of the support activities operating under revolving-fund financing (Thompson, 1994, pp. 66–67; Jones & McCaffery, 2005, p. 8). The argument, once again, is based on the private sector model: Just as a multi-division corporation must produce a single consolidated financial report for itself every year so that owners, investors, and managers will know how the corporation (as a whole) is doing, so "must" the DoD produce a single consolidated statement every year—and doing that obviously requires an integrated system of accounting that covers everything the department does.[9] That perspective helps to explain why the financial management sections in the *Government Management Reform Act* of 1994 extended the CFO Act requirement for financial statements to all of the DoD's activities, not just its "commercial" ones.[10] It also helps to explain why the GAO (General Accounting Office, renamed the Government Accountability Office in 2004) has been insisting ever since the CFO Act was passed that the DoD must develop a single, overarching "*enterprise architecture*" to control the development and operation of all of its financial-management systems, no matter where they may be operating. The GAO's argument—first made in a report on "system architectures" (GAO, 1992) that GAO released soon after the CFO Act became law—is that unless and until the DoD has a single, integrated system in place that guarantees all defense activities are using financial data defined the same way and are following the same rules for classifying and recording financial transactions, it will be impossible for the DoD to produce a single, consolidated financial report for itself every year capable of winning an unqualified audit opinion, as the CFO Act (as extended by GMRA) requires.

A KEY QUESTION

Given its "failure" every year to comply with the requirements of the CFO Act, the DoD has not been in a position to ask (or even raise) the question of who, exactly, would benefit from having a consolidated financial report for the defense department, if one were to be produced. Instead, the department has been forced to devote a substantial amount of time, effort, and money to what has become the never ending pursuit of a "business enterprise architecture" (as defined by the GAO and required by the Clinger-Cohen Act) to demonstrate that progress is being made in the pursuit of CFO compliance.[11]

But the question still stands: Who, exactly, is going to use a consolidated financial report for the DoD, and how, exactly, will they use it to make any decisions that matter for the department?

As it turns out, Anthony himself provided an answer to that question. In an important paper published in the *Journal of Government Financial Management* in 1996, 6 years after the CFO Act had been passed and 10 years before his death, Anthony observed (ruefully to be sure) that even if the DoD were to eventually start producing auditable CFO-style financial reports accompanied by clean audit opinions, it would not make one iota's worth of difference—either then or later—in how the Congress would go about funding the department each year or how DoD managers would go about running it. In the end, those decisions are driven by world events, politics, and (as Anthony explains in his paper) the primacy of the budgeting process—and none of those things is ever going to change (Anthony, 1996).

WHO, EXACTLY, IS GOING TO USE A CONSOLIDATED FINANCIAL REPORT FOR THE DoD, AND HOW, EXACTLY, WILL THEY USE IT TO MAKE ANY DECISIONS THAT MATTER FOR THE DEPARTMENT?

Even if the financial statements are never going to be used, and if somehow things could be arranged so that the budgeting process was not so dominant, could financial accounting results be used by DoD managers for decision making? The CFO strategy assumes they could. Is that assumption valid?

It is true that the raw financial data that financial accounting and *managerial cost accounting* use as input are always the same. But accounting textbooks distinguish between financial accounting and managerial cost accounting, noting that the former is meant to serve external users such as stockholders, investors, and creditors, while the latter is meant to serve internal users such as managers. As a result, financial accounting and reporting is governed by a strict set of rules—Generally Accepted Accounting Principles (GAAP)[12]—but managerial cost accounting is not. Differences exist, therefore, between how financial accounting and managerial cost accounting summarize the raw data. Indeed, in their classic text on managerial cost accounting, Robert Kaplan and Robin Cooper of Harvard assert that financial accounting systems designed to satisfy external reporting requirements are "completely inadequate" for either "estimating the costs of activities and business processes" or for "providing useful feedback to improve business processes" (Kaplan & Cooper, 1998, p. 14). It is certainly clear that financial statements by themselves do not give internal managers the information they need to understand and manage internal costs. If they did, business competitors could simply examine the public financial statements of their rivals in order to understand their internal cost structures in detail.

One of the most unfortunate aspects of DoD's pursuit of CFO financial accounting over the last 20 years has been that it has diverted resources that might otherwise have been applied to the development of better managerial cost accounting in the department. One telling example illustrates the point: Cost accounting is not and never has been part of the charter of the Defense Finance and Accounting Service (DFAS). When it was formed in 1991, DFAS was charged to work on achieving CFO compliance (i.e. financial accounting) at the department. Today, 18 years later, the DFAS charter still does not include cost accounting as a DFAS mission.

But we're getting ahead of the story. Even though Anthony formulated the basic ideas of the CFO strategy in the 1960s, he was not successful in getting the strategy implemented at the department. Another 25 years would pass before the strategy would make itself felt again at the DoD—in the form of the CFO Act of 1990. The next section describes how that happened.

During his tour at the Pentagon, Anthony's effort to establish private sector-style, accrual-based accounting influenced the thinking of many people. Two members of the financial management community at the time who took Anthony's ideas to heart were Charles A. Bowsher, who served as the Assistant Secretary of the Navy for Financial Management from 1967 to 1971, and Donald B. Shycoff, who was working as a program and budget analyst in the DoD Comptroller's office when Anthony joined the department in 1965. Twenty-five years after their original contact with Anthony, Messrs. Bowsher and Shycoff would go on to play key roles in bringing the CFO strategy to bear at the DoD.

After leaving his Navy position in 1971, Mr. Bowsher returned to Arthur Andersen & Co., where he became the partner responsible for all of the firm's government services work. During his next 10 years at Arthur Andersen, Mr. Bowsher worked on efforts to encourage public discussion of the need for financial reporting in the public sector. In particular (working with then Comptroller General, Elmer Staats), Mr. Bowsher led a research project at Arthur Andersen designed to demonstrate how financial statements for the federal government could be constructed. Then in 1981, Mr. Bowsher was selected by President Ronald Reagan to succeed Mr. Staats as Comptroller General and head of the GAO.[13] Mr. Bowsher served in that position for 15 years, from 1981 to 1996. During that time he, and the GAO under his leadership, played a major and influential role in the development and passage of the 1990 CFO Act.[14]

Under Mr. Bowsher's leadership, the GAO was also active in developing the ideas underlying the Clinger-Cohen Act of 1996, which required every executive-branch agency in the government to establish an "integrated information technology architecture" for its business information systems. Like the CFO Act, the Clinger-Cohen Act had the effect of making management recommendations from the Comptroller General and GAO relating to financial accounting into the law of the land.[15]

While Mr. Bowsher was leading the GAO, Donald Shycoff would go on to become the Principal Deputy Comptroller at DoD from 1989 to 1992 and Acting DoD Comptroller from 1992 to 1993. During those 4 years, he would organize and lead the development of the Defense Business Operations Fund (DBOF). The DBOF was established in 1991, the year after the CFO Act became law. As Mr. Shycoff himself has said, the express purpose of the DBOF was to expand the use of revolving-fund financing in line with what Anthony had proposed 25 years earlier (Shycoff, 1995).

Messrs. Bowsher and Shycoff have both publicly acknowledged the influence that Anthony had on their thinking (Shycoff, 1995; Jensen & Bowsher, 1997).

THE ARGUMENTS FOR THE CFO STRATEGY HAVE CHANGED OVER TIME

By the time the CFO and GMRA legislation was being enacted in the early 1990s, the promotional arguments for the CFO strategy had become somewhat more negative in tone ("this will help reduce waste, fraud, and abuse") compared to the ones Anthony had made 25 years earlier ("this will help DoD operate more efficiently"). The shift in tone was the result of the "waste, fraud, and abuse" scandals in defense contracting that received great attention in the 1980s, combined with the widespread (but faulty) assumption among non-accountants that the primary purpose of financial audits was to detect fraud.[16] By the mid to late 1990s, however, as the pursuit of CFO compliance became more active, financial managers began to re-discover that unless the accounting system delivers cost information useful for day-to-day management, operating managers (including managers in revolving-fund activities) will not pay much attention to what the accounting system produces.[17]

The recognition that better managerial cost accounting is what internal managers need, not financial accounting, underlies the most recent argument that proponents have been making for continuing the pursuit of CFO compliance. The argument is that the "discipline and controls" being built into DoD financial systems to make the production of auditable statements possible will, along the way as it were, lead to higher-quality and more reliable financial data—and that will help to improve managerial cost accounting, even if the CFO financial statements themselves are of no use to internal managers. As discussed earlier, the problem with that argument is that it assumes the expense data that are defined and collected in a financial accounting system will—when rolled up by a managerial cost accounting system—be relevant to the decisions that internal managers make each day.

A specific example from the supply business area helps to explain why that assumption is false. To do their part in helping to make sure national security is delivered in the future, DoD supply managers who manage spare parts have a forward-looking job. That is, it is their responsibility to do things today (project demands, optimize spares mixes, place orders, etc.) so that as many of the right items as possible will be on the shelf in the future when mechanics will need them—not to "sell" spare parts that have been purchased and brought into the supply system in the past. The day-to-day "costs" of doing that forward-looking mission are captured in the obligations that supply managers make during budget execution—not by the historical "cost of goods sold" expense entries (even if the entries have been blessed by auditors) made under private sector-style financial accounting.

The population and costs of spare parts tend to change over time as weapon systems are used and are continuously being modified, upgraded, and modernized. The "cost of goods sold" for spare parts sold by a supply activity today, therefore, may have very little to do with the current obligations that must be made to ensure that suitable spare parts will be on the supply shelf in the future when needed. Extensive research on the demand for military spare parts, for example, has shown that even when only peacetime training is taking place, the failure patterns and demand rates for many different reparable-type spares (which are more expensive than consumable repair parts) can be and often are quite volatile from one year to the next, even when annual operating tempos are relatively stable (Crawford, 1983; King & Mattern, 1985; Keating & Camm, 2002; Peltz, Colabella, Williams, & Boren, 2004).

The above argument becomes even clearer at the weapon system level. Although historical costs certainly have to be taken into account (and they are) when developing the estimates of what new weapon systems will cost, it is the future costs of weapon systems that acquisition program managers are trying to manage each day, not the historical purchase costs of systems already in the inventory. Although well meaning, the "data discipline" being enforced in the pursuit of financial accounting and CFO compliance at the DoD is not helping to improve the department's managerial cost accounting capabilities.[18]

WHY, IN THE END, THE CFO STRATEGY IS NOT GOOD FOR THE DoD

As the preceding discussion is meant to suggest, neither Anthony's original arguments, nor the current "data discipline" arguments, stand up to the most basic reason why continuing the pursuit of the CFO strategy is *not* a good idea for the DoD. That reason is the following: The compact that exists between the DoD and Congress, in terms of what the Congress (on behalf of the country) wants from the DoD, and what DoD is working to provide, is a forward looking compact. That is, once agreement has been reached on future threats, the Congress wants the DoD to do the best job it can to assure that the resources and capabilities that will come into existence in the future as a result of current decisions will be sufficient to meet those threats. That implies the costs that the Congress and the DoD should most care about when thinking about efficiency are the obligations that are being made during execution in order to provide for national security in the future, not the historical costs tracked by private sector-style financial accounting.

CAN THE DoD CHANGE COURSE?

The CFO Act is still the law. For the DoD to move away from the production of CFO financial statements, either Congress needs to amend the CFO Act as it applies to the DoD (which is not likely to happen) or the DoD needs to propose new "accounting initiatives" to replace its current CFO compliance efforts. The new initiatives must still support the basic intent of the CFO Act—to improve DoD's effectiveness, efficiency, and fiscal responsibility—but without requiring the production of private sector-style financial statements. More and better managerial cost accounting would serve that purpose, but it needs to recognize the primacy of the budgeting process. Is it possible to expand the capabilities of the department's budgetary accounting and reporting systems to include managerial cost accounting capabilities?

One possibility would be to explore whether the data elements called "Object Class Codes" in current budgetary systems could be expanded. Object Class Codes report obligations by the nature of the goods or services being purchased. For example, in budgetary accounting records, "Object Class Code 21" is attached to any obligation made anywhere in the department to cover the costs of "Travel and Transportation of Persons" (e.g., air tickets, rental cars, lodging, per diem, etc.). That makes it possible (using any data system that can roll up obligation amounts and their Object Class Codes), to determine what DoD activities at any level are spending for travel (assuming budgetary accounts are kept for the activity). That information would clearly be of interest to a manager trying to determine, for example, whether an activity could accomplish its mission more efficiently by investing in an electronic conferencing system, thereby reducing business travel.

In a cost study done for the Defense Travel Management Office in 2007, for example, Object Class Code 21 data were used to obtain an estimate of the total direct costs of (i.e., obligations for) DoD business travel in FY06. In comparison with totals obtained from other sources (travel voucher sums, DFAS disbursements, travel card charges, etc.), the Object Class Code 21 data captured as much if not more of DoD's travel costs than all other sources combined (Mandelbaum et al., 2008). As another example suggesting the proposed approach may have merit, one reviewer of a previous version of this article noted that in a GPRA pilot project the Navy conducted several years ago, operational managers in the Atlantic Fleet made significant changes in the allocation of funds across the "products" the Fleet produces (e.g., trained carrier battle groups ready for deployment) based on information collected in its budgetary accounting system.

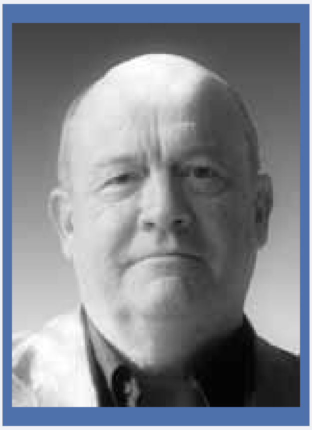
Object Class Codes for the entire government are defined and maintained by the Office of Management and Budget (OMB). The codes the DoD uses are published in Volume 1, Appendix A of the DoD Financial Management Regulation (FMR). Actual obligations by Object Class Code are collected by the DoD Comptroller's office every year, so the codes are being used. In particular, the "FAD 740" report in the annual "Financial Summary Tables" on the Office of the Under Secretary of Defense (Comptroller) Web site classifies DoD's total obligations each fiscal year across the approximately 30 different Object Class Codes currently used in the department's budgetary accounting systems.

Expanding the number of Object Class Codes could be done by selecting from the output measures that have been developed for the Performance Assessment Rating Tool (PART) exercises the department has been doing in response to the 1993 Government Performance and Results Act (GPRA). The Obama administration has announced plans to improve PART by making the system more output-oriented, which would fit well with the idea of expanding Object Class Code definitions so that they can do a better job of describing the outputs that defense obligations are buying.

CONCLUSIONS

Even if the DoD is able to say at some point that it has achieved CFO compliance, the consolidated financial statements that will have been produced, will not be used to allocate resources either by the Congress or by managers at any level in the DoD. To obtain the more practical information needed to work on improving effectiveness, efficiency, and fiscal responsibility, the DoD needs to convert its CFO-compliance efforts into efforts aimed more directly at establishing relevant managerial cost accounting—tied to the budgeting process—that both Congress and DoD managers will be able to use.

Author Biography



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ENDNOTES

1. Budgetary accounting is what federal agencies have been required to do for 90 years, ever since the passage of the Budget and Accounting Act in 1921. The purpose of budgetary accounting is to allow federal agencies and activities to keep track of the obligation authority and other budgetary resources they receive from the authorization and appropriations process. The Statement of Budgetary Resources (SBR) is the single financial statement that federal agencies are required to produce each year under budgetary accounting. The SBR is subject to independent audit to assure that budgetary resources have been allocated and used in accordance with all laws and controls governing their limits and use.
2. In its recommendations on how to manage the newly formed DoD, the first Hoover Commission (1947–1949) called for the use of "businesslike practices for the provision of common services." Forty years later, the 1986 Packard Commission Report on Defense Management would include the following statement by the Commission members: "Defense acquisition represents the largest and, in our judgment, the most important *business enterprise* in the world [italics added]." Today, continuing that tradition, the DoD Business Transformation Agency uses the term "Core Business Missions" when referring collectively to the support activities the department operates in the following six functional areas: logistics (i.e., central supply and maintenance, warehousing, distribution, and transportation); acquisition; information management; human resources management; real property and installations management; and financial management.
3. The achievement of CFO compliance has been a goal of every major business-process reform effort at the DoD for 20 years, including: the Defense Management Review and Corporate Information Management (CIM) (1988–1992); the Defense Performance Review and Acquisition Reform (1992–1996); the Business Reform Initiative and Acquisition Excellence (1996–2000); the Financial Management Modernization Program (2001–2003); Business Management Modernization (2003–2005); and Business Transformation (2006–present). A study would be required to determine how much has been spent specifically on the pursuit of CFO compliance, but it is not unreasonable to think the total has been in the billions of dollars. One recent example offers a glimpse into the sums that can be involved. In February 2005, the DoD Inspector General let a three-year, multiple-award, IDIQ (Indefinite Delivery, Indefinite Quantity) contract to 20 professional private sector accounting firms specifically "to assist the DoD in improving the reliability of its CFO Act financial statements." The dollar ceiling on the contact was $977.5 million.
4. Some government activities—such as revolving fund activities—have other sources of "income" (revenue) besides appropriations. The revenues that revolving fund activities collect are called exchange revenues. As a consequence, the "results-of-operations" income statements required by the CFO Act have two parts: the Statement of Net Costs, which adjusts results of operations for the year based on exchange revenues, and the Statement of Net Position, which reports the results of operations relating to "non-exchange revenues" (i.e., appropriations).
5. In an attempt to show progress, the DoD has begun reporting the achievement of "partial" CFO compliance. The March 2009 FIAR Plan, for example, reports that unqualified audit opinions have been achieved on "39 percent" of the department's *total* assets and liabilities at the end of 2008. A problem with such claims is that they appear to be self-contradictory. If the DoD does not know what its *total* assets and liabilities were at the end of 2008, how can the department claim an opinion of 39 percent of that total?
6. If a firm is reporting profits but has not taken into account future costs that it either knows or expects to have to pay—e.g., warranty payments, future environmental cleanup costs, retirement payments, etc.—its financial statements will not give investors all the information they need to make fully informed investment decisions. Separate from how it treats inventory held for sale, therefore, accrual accounting also makes it possible for firms to deal with such future expenses by allowing the effect of such future expenses to be reflected on the financial statements even though it may be many years before cash is paid out. It

is this aspect of accrual accounting that fits with the CFO Act's goal of improving fiscal responsibility in government. The assumption is that if future costs are incorporated into the financial statements, decision makers will take such costs into account when making program decisions. Proponents of CFO compliance have pointed to this aspect of accrual-based accounting as one of the reasons why the DoD should "stay the course" with CFO compliance, even though other options for providing visibility of the department's future liabilities would seem to be possible.

7. Dr. Robert N. Anthony acted on his ideas about revolving-fund financing when he was the Comptroller. For example, he personally led the effort that began in 1965 to place all of the department's aeronautical maintenance depots under revolving-fund financing—and in 1968 all of the department's aeronautical maintenance depots did, in fact, become "industrially funded," which they are to this day.

8. Such "purchases" of national security by the country and its citizens, of course, are made indirectly and "in bulk" through the Congressional appropriations process, rather than directly and individually each time a revolving-fund transaction takes place, so the business analogy is not perfect. Nevertheless, given the CFO strategy's goal of setting up accrual-based financial accounting for the "businesses" of defense, revolving-fund arrangements provide a way of saying that expenses (operating costs) and revenues (defense appropriations) are being matched. All of the DoD's revolving-fund support activities use accrual-based accounting as it is described here.

9. In the private sector, multidivision corporations (like GE or IBM) must produce financial statements showing the financial position and results of operations for the corporation viewed a single financial entity. Financial transactions that take place between divisions within such corporations are done using "transfer prices." When assembling the corporate financial statements at the end of the year, it is necessary to keep track of who paid what to whom within the corporation over the course of the year to avoid double counting in the corporate statements. A "consolidated" financial statement, therefore, is one in which all the necessary "eliminating entries" have been made so that the corporate financial statements accurately reflect the financial position and results of operations (i.e., income) of the corporation as a whole. In the DoD setting, the coin of the realm for execution is obligation authority (OA), so revolving-fund sales within the DoD are booked as intra-governmental transfers of OA on the DoD's books, based on the transfer prices charged by the revolving-fund activities. The magnitude and complexity of the intra-departmental transfers that are generated—both among the revolving-fund activities themselves and between those activities and the department's direct-funded activities—are enormous. Because the DoD (and its major Components–the Army, Navy, and Air Force) are each viewed as single corporate entities by the CFO Act, they are required to produce consolidated financial statements, just as multidivisional corporations in the private sector must do. But the DoD's accounting systems, of course, were never designed to keep track of the "eliminating entries" required to produce private sector-style, consolidated financial statements. After many years of unsuccessful internal effort to solve its intra-governmental eliminations "problem," the DoD has now turned to commercial Enterprise Resource Planning (ERP) systems in the hope that they will be able to untangle the situation. For example, in the Defense Agencies Initiative (DAI), the Business Transformation Agency is pursuing an Oracle-based ERP system that is supposed to become, upon project completion, the integrated financial management system for 28 different defense agencies. A central DAI goal is to show it is possible for a commercial ERP system to produce a consolidated financial statement for 28 different agencies viewed as a single corporate entity. The first phase of the DAI covers an initial test group of six agencies and is supposed to be completed in 2010.

10. Before being expanded by the 1994 GMRA, the CFO Act required private sector-style financial statements only for "commercial" activities in government, i.e., activities where "businesslike" financial transactions take place, such as revolving-fund activities.

11. Since its establishment in FY 2006, the DoD's Business Transformation Agency (BTA) has devoted substantial effort to the production of congressionally required Enterprise Transition

Plan (ETP) and Business Enterprise Architecture (BEA) documentation. The latest ETP, released in September 2008, is an 8.3Mb file available at the BTA Web site. A Congressional Report issued in March 2009 is also available on the BTA Web site. Based on current plans, the BTA will eventually become an organization of roughly 350 personnel, including both government and contract staff. Total funding for all BTA budget lines was $335.8 million in FY07 and just over $400 million in FY09. That includes operational funding for the BTA's internal operations and staff as well as procurement funding for all 27 of the DoD-wide systems acquisitions programs currently proceeding under BTA program management.

12. Generally accepted accounting principles (GAAP) refers to the extensive set of formally defined standards, conventions, and rules for recording financial transactions and preparing financial statements that professional accountants follow. The primary job of the auditor of the financial statements for a business is to examine and test the business' accounting records to provide assurance that financial accounting and reporting has been done in accordance with GAAP and (thus) "fairly presents" the financial position and results of operations for the business for the year in question.
13. The Comptroller General is appointed for a 15-year term and serves as the head of the Government Accountability Office (GAO). When it was created in 1921, the GAO was called the General Accounting Office. Congress changed the name in 2004 to reflect the shift in the GAO's mission that has taken place over the last 40 years—away from accounting and auditing and into program evaluation.
14. As the Comptroller General, Mr. Bowsher was influential in the passage of the Single Audit Act of 1984, which required audits of state and local governments and other recipients of federal grant, and in the discussions of the Federal Management Reorganization and Cost Control Act, which was first proposed by Senator William Roth in 1986 and that evolved to eventually become the CFO Act of 1990. In remarks he made upon his induction into the Accounting Hall of Fame in 1996, Mr. Bowsher said the following about his role in the development and passage of the CFO Act:

    > In 1933, Colonel Carter (Arthur Carter, President of the New York Society of CPAs) was able to persuade the Congress with one testimony to enact the basic legislation that required annual independent audits for all public corporations. It has taken me most of my 15-year term, many audits of the Internal Revenue Service, the Air Force, the Customs Service and other agencies, and well over 20 testimonies before Congressional committees to achieve similar legislation for the public sector. I can only conclude that Colonel Carter was a more persuasive individual.

15. The GAO has continued to vigorously promote the development and use of enterprise architectures (EA) across the government, including at the DoD. An August 2006 GAO report, for example (GAO-06-31), concludes by recommending that the heads of 27 major departments and agencies, including the Secretary of Defense, "ensure that their respective EA programs develop and implement plans for fully satisfying each of the conditions in our enterprise architecture management maturity framework"—a construct first described in an April 2003 GAO report, GAO-03-584G.
16. Most accountants who do audits will say that the primary purpose of a financial audit is not to look for fraud by management but rather to verify that the financial statements fairly present the financial position and results of operations (of the company involved) in accordance with GAAP. To make the distinction, financial statement auditors will sometimes describe themselves as being "watchdogs" rather than "bloodhounds."
17. One important exception to this rule is that operating managers do pay close attention to reports of Anti-Deficiency Act violations generated by the budgetary accounting system.
18. For more evidence supporting this point, readers are encouraged to view the tutorial on the department's Standard Financial Information System (SFIS) initiative—available at: http://www.bta.mil/products/training//SFIS/index.html. The tutorial makes it clear that the primary purpose of the SFIS is to facilitate the production of CFO-style financial statements.