



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202-4704

December 4, 2003

MEMORANDUM FOR ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL
MANAGEMENT AND COMPTROLLER)

SUBJECT: Independent Auditor's Report on the Air Force Working Capital Fund Fiscal
Year 2003 Principal Financial Statements (Report No. D-2004-027)

The Chief Financial Officers Act of 1990, as amended, requires the Inspector General of the Department of Defense to audit the accompanying Consolidated Balance Sheet of the Air Force Working Capital Fund as of September 30, 2003 and 2002, the related Consolidated Statements of Net Cost and Changes in Net Position, and the Combined Statements of Financing¹ and Budgetary Resources for the fiscal years then ended. These financial statements are the responsibility of Air Force management. Air Force is also responsible for implementing effective internal control and for complying with laws and regulations. We are including the required reports on internal control and compliance with laws and regulations.

Disclaimer of Opinion on the Financial Statements

The Assistant Secretary of the Air Force (Financial Management and Comptroller) acknowledged that the Air Force previously identified material weaknesses in internal control and instances of noncompliance with laws and regulations that continue to affect the current period. As a result of those conditions, management acknowledged that the financial data reported in the financial statements were unreliable. Therefore, we did not perform auditing procedures to support material amounts on the financial statements. In addition, other auditing procedures were not performed because Section 1008(d) of the FY 2002 National Defense Authorization Act requires the Inspector General of the Department of Defense to perform only the audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. These material deficiencies also affect the reliability of certain information contained in the accompanying Management's Discussion and Analysis and certain other information—much of which is taken from the same data sources

¹ The Office of Management and Budget requires a Consolidated Statement of Financing, instead of the Combined Statement of Financing prepared by the Air Force.

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as the principal financial statements.² These deficiencies would have precluded an audit opinion. As described above, we are unable to express, and we do not express, an opinion on the referenced financial statements and other information.

Summary of Internal Control

In planning and performing our audit, we considered the Air Force internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance, but not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance because previously identified reportable conditions,³ all of which are material, continue to exist in the following areas.

- financial management systems
- policies and practices
- Fund Balance with Treasury
- Inventory
- Operating Material and Supplies
- Government furnished material and contractor acquired material
- accounting entries
- Intragovernmental Eliminations
- Statement of Net Cost
- Statement of Financing

A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance that are material in relation to the financial statements would be prevented or detected on a timely basis. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on material internal control weaknesses.

² Other information includes the Supporting Consolidating and Combining Financial Statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

³ Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

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Summary of Compliance with Laws and Regulations

Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continue to exist in the following areas:

- Federal financial management systems requirements,
- generally accepted accounting principles, and
- United States Government Standard General Ledger.

Therefore, we did not determine whether Air Force was in compliance with all applicable laws and regulations related to financial reporting. See the Attachment for additional details on compliance with laws and regulations.

In order for DoD to comply with statutory reporting requirements and applicable financial systems requirements, the Under Secretary of Defense (Comptroller)/Chief Financial Officer is developing the DoD-wide Business Enterprise Architecture. Until the architecture is fully developed and implemented, the Air Force will be unable to fully comply with the statutory reporting requirements.

We caution that other noncompliance may have occurred and not been detected. Further, the results of our limited procedures may not be sufficient for other purposes. Our objective was not to express an opinion on compliance with applicable laws and regulations.

Management Responsibility

Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles,
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 are met,

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- ensuring that Air Force financial management systems substantially comply with Federal Financial Management Improvement Act (FFMIA) of 1996 requirements, and
- complying with applicable laws and regulations.



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Attachment
as stated

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Reports on Internal Control and Compliance with Laws and Regulations

Internal Control

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data is accumulated, recorded, and reported properly; and that assets are safeguarded. We did not perform tests of internal control over financial reporting for the Air Force, and we did not obtain sufficient evidence to support or express an opinion on internal control. We limited our audit tests because previously identified reportable conditions, all of which are material, continue to exist in the following areas. These material internal control weaknesses significantly impair the ability of Air Force to detect and prevent fraud or theft of assets. A high risk of material misstatements will continue to exist until the internal control deficiencies are corrected.

Air Force Financial Management Systems

- The Air Force financial management systems do not substantially comply with Federal financial management systems requirements. For details, see Notes 1.A. of the financial statements.
- The Air Force has not fully implemented the USSGL at the transaction level. For details, see Note 1.D. of the financial statements.
- The Air Force is unable to implement fully all elements of GAAP and Office of Management and Budget (OMB) Bulletin 01-09 due to limitations in financial management processes and systems, including non-financial feeder systems and processes. For details, see Note 1.A. of the financial statements.
- The Air Force generally records transactions on a cash (budgetary) basis, not on an accrual basis as required by GAAP. The amounts presented in the Consolidated Statement of Net Cost are based on budgetary obligations and disbursements and collection transactions, and are adjusted to record known accruals for major items and known imputed expenses. For details, see Note 19.A. of the financial statements.
- Air Force systems are not transaction driven for budgetary accounts. Therefore, in some cases proprietary and statistical accounts are used to develop the Report on Budget Execution and Budgetary Resources (SF-133) and Statement of Budgetary Resources for reporting budgetary data. For details, see Note 1.C. of the financial statements.

Policies and Practices

- Air Force resource managers do not always maintain adequate documentation or use transaction subsidiary ledgers and special journals to support recorded trial balance accounts.

- Air Force and Defense Finance and Accounting Service personnel do not perform reconciliation and system validations to verify the accuracy of accounts receivable from foreign military sales, progress payments to contractors, and accounts payable from the material support division.

Fund Balance with Treasury

The Air Force Working Capital Fund (WCF) continues to experience problem disbursements. As discussed in Note 21.B. to the financial statements, unmatched disbursements increased slightly to \$2,813,000 at the end of FY 2003 from \$2,548,000 at the end of FY 2002. Negative unliquidated obligations decreased significantly to \$6,498,000 at the end of FY 2003 compared to \$11,616,000 at the end of FY 2002.

In addition, Note 5 to the financial statements showed that the accounts receivable line item balance was reduced by \$17,631,700 to close the undistributed collections general ledger account. Similarly, Note 12 to the financial statements showed that the accounts payable line item was reduced by \$580,943,000 to close the undistributed disbursements general ledger account.

Balance Sheet

- Property, Plant, and Equipment values cannot be verified in accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 6, "Accounting for Property, Plant, and Equipment." Further, Property, Plant, and Equipment has not been properly recorded. For details, see Note 10 of the financial statements.
- Air Force supply management systems do not provide sufficient audit trails to confirm and value the in-transit inventory reported as part of inventory held-for-sale on the Consolidated Balance Sheet.

Operating Materials and Supplies

Cost of Goods Sold and Work In Progress are not recorded in accordance with SFFAS No. 3, "Accounting for Inventory and Related Property." Instead of using historical costs, the Air Force WCF values operating material and supplies based on standard price. Further uncertainties exist regarding the existence and completeness of quantities used to derive the balances reported in the Balance Sheet for operating material and supplies. For details, see Note 1.M. of the financial statements.

Inventory

Cost of Goods Sold and Work In Progress are not entirely recorded in accordance with SFFAS No. 3, "Accounting for Inventory and Related Property." Instead of using historical cost, the Air Force WCF values most inventory at latest acquisition cost. Further uncertainties exist regarding the existence and completeness of quantities used to derive the balances reported in the Balance Sheet for inventory. For details, see Note 1.M. of the financial statements.

Government Furnished Material

The General Property, Plant, and Equipment line item on the Balance Sheet does not include all Government furnished equipment in the hands of contractors whose value exceeds the capitalization threshold. The Air Force is developing policies and a contractor reporting system so that the Air Force WCF will report appropriate values. For details, see Note 1.O. of the financial statements.

Accounting Entries

The Air Force had not implemented adequate procedures to support and document all journal vouchers in the Air Force WCF. For details, see Note 1.A. of the financial statements.

Intragovernmental Transactions

- The Air Force cannot accurately identify all intragovernmental transactions by customer; and cannot be assured that transactions occurring between entities within DoD, or two or more Federal agencies, are eliminated. For details, see Note 1.G. of the financial statements.
- The Air Force cannot reconcile intragovernmental accounts receivable or accounts payable balances, or reconcile intragovernmental revenue balances with its trading partners. For details, see Note 1.G. of the financial statements.

Statement of Net Cost

- The Air Force does not accumulate cost information as required by GAAP. The Air Force identifies costs in the Consolidated Statement of Net Cost based on the major appropriation groups funded by Congress instead of being based on major programs and activities as set forth in SFFAS No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government." For details, see Note 1.D. of the financial statements.
- The Air Force WCF has not fully implemented the percentage-of-completion revenue accounting method for revenue and costs as required by SFFAS No. 7, "Accounting for Revenue and Other Financing." For details, see Note 1.E. of the financial statements.
- The Air Force does not recognize an allowance for loss on accounts receivable amounts with other Federal agencies. For details, see Note 1.K. of the financial statements.

Statement of Financing

The Air Force cannot reconcile budgetary data with proprietary expenses and assets capitalized without making unsupported adjustments to resolve differences. For FY 2003, this adjustment was \$1.1 billion compared to a negative \$1.4 billion adjustment in FY 2002. Additionally, the Air Force prepared the Statement of Financing on a combined basis, instead of the consolidated basis required by OMB Bulletin No. 01-09, "Form and Content of Agency Financial Statements." For details, see Note 22 of the financial statements.

Compliance with Laws and Regulations

Management is responsible for compliance with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continue to exist. Therefore, we did not determine whether Air Force was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to express an opinion on compliance with applicable laws and regulations.

The Air Force is required to comply with the following financial management systems reporting requirements.

The Federal Financial Management Improvement Act of 1996 requires Air Force to establish and maintain financial management systems that comply substantially with the Federal financial management systems requirements, applicable generally accepted accounting principles, and the United States Government Standard General Ledger at the transaction level. In addition, the Federal Managers' Financial Integrity Act of 1982 requires Air Force to evaluate the systems and to annually report whether those systems are in compliance with applicable requirements. The Chief Financial Officers Act of 1990 requires DoD to prepare a 5-year Financial Management Plan describing activities that DoD will conduct during the next 5 years to improve financial management.

The Air Force acknowledged that many of its critical financial management and feeder systems do not comply substantially with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In an attempt to comply with statutory reporting requirements and applicable financial systems requirements, DoD is developing a DoD-wide Business Enterprise Architecture. The architecture is intended to provide a "blueprint" of the Department's financial management systems and processes to initiate a comprehensive financial management reform effort. Until the architecture is fully developed and implemented, Air Force will be unable to fully comply with the statutory reporting requirements. Therefore, we did not perform tests of compliance for these requirements.

Audit Disclosures

Based on audit procedures performed, we obtained a limited understanding of internal control. However, we were unable to obtain sufficient understanding of internal control in order to plan the audit and to determine the nature, timing, and extent of tests to be performed.

The Assistant Secretary of the Air Force (Financial Management and Comptroller) acknowledged to us on June 20, 2003, that the Air Force financial management systems do not comply substantially with Federal financial management system requirements, GAAP, the USSGL at the transaction level. These deficiencies in Air Force critical financial feeder systems limited its ability to present information accurately and in conformance with GAAP. As a result, we were unable to obtain adequate evidential matter to form or express an opinion on the financial statements, internal control, and compliance with laws and regulations. Furthermore,

we were unable to design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.

In addition, we were unable to conduct sufficient audit follow-up work related to the deficiencies identified in the FY 2002 Air Force financial statement audit. Finally, we did not perform audit tests of Air Force compliance with certain provisions of the Antideficiency Act, Debt Collection Improvement Act, Federal Credit Reform Act, Pay and Allowance System for Civilian Employees, and the Prompt Payment Act.

This report does not include recommendations to correct material control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.