

Inspector General

United States
Department of Defense



Report on DoD Compliance with
Federal Managers' Financial Integrity
Act of 1982

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Acronyms

ASA	Annual Statement of Assurance
DoD IG	Department of Defense Inspector General
FMFIA	Federal Managers' Financial Integrity Act of 1982
GAO	Government Accountability Office
IAR	Independent Auditor's Report
OMB	Office of Management and Budget
PAR	Performance and Accountability Report
USD(C)	Under Secretary of Defense (Comptroller)/Chief Financial Officer



INSPECTOR GENERAL
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May 8, 2007

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/ CHIEF
FINANCIAL OFFICER

SUBJECT: Report on DoD Compliance with the Federal Managers' Financial Integrity Act
of 1982 (Report No. D-2007-093)

We are providing this report for your information and use. We considered management comments on a draft of this report in preparing the final report. The Under Secretary of Defense (Comptroller) comments conformed to the requirements of DoD Directive 7650.3; therefore, additional comments are not required.

We appreciate the courtesies extended to the staff. Questions should be directed to me at (703) 325-5777 (DSN 221-5777) or Mr. Charles O. Egu at (703) 325-5961 (DSN 221-5961). The team members are listed inside the back cover. See Appendix C for the report distribution.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink, appearing to read "Paul G. Granetto".

Paul G. Granetto, CPA
Assistant Inspector General and Director
Defense Financial Auditing Service

Department of Defense Office of Inspector General

Report No. D-2007-093

May 8, 2007

(Project No. D2006-D000FA-0106.000)

DoD Compliance with the Federal Managers' Financial Integrity Act of 1982

Executive Summary

Who Should Read This Report and Why? DoD management and personnel in the Services and Defense agencies who prepare, review, and approve Annual Statements of Assurance (ASAs) will find this report of interest. The report discusses DoD compliance with the Federal Managers' Financial Integrity Act of 1982 and the completeness of supporting statements from DoD Components.

Background. In 1982, Congress passed the Federal Managers' Financial Integrity Act that requires Federal agencies to develop cost-effective internal accounting and administrative controls. The Act requires each agency head to provide an ASA stating whether internal accounting and administrative controls are designed adequately and operating effectively. This statement should include any material internal control weaknesses identified, and include plans and schedules for correcting the weaknesses.

According to Office of Management and Budget and DoD Guidance, agency managers should continuously monitor and improve the effectiveness of internal controls associated with their programs. Managers should also use other sources of information such as Inspector General or Government Accountability Office reports as a supplement to their own judgment to provide the internal control assessment in the ASA.

Results. The DoD and Military Departments' ASAs were not always complete and may contain inaccurate information because DoD did not fully consider all sources of information in identifying and reporting material weaknesses. In addition, DoD provided a level of assurance on internal control over financial reporting that was not consistent with the scope and pervasive nature of the DoD known material weaknesses. Finally, DoD reported target correction dates for its systemic weaknesses that are not supported by the Components' ASAs. As a result, DoD managers may not be able to effectively monitor and report on the status of material weaknesses, take timely action to correct internal control deficiencies, and meet the intent of the Federal Managers' Financial Integrity Act and Office of Management and Budget Circular A-123.

DoD Components need to provide thorough documentation if they decide not to include auditor-identified and DoD-acknowledged financial reporting weaknesses when preparing the ASAs. Also, DoD should provide a level of assurance on its ASA for financial reporting consistent with the status and scope of known internal control weaknesses. In addition, DoD should revise the "Correction Target Dates" reported in its Performance and Accountability Report to be consistent with the latest reported target date from the Components' ASAs.

Management Comments and Audit Response. The Acting Deputy Chief Financial Officer concurred in principle with the recommendations, but emphasized that it is management's decision on whether to report an internal control weakness as material when preparing the ASAs. We will continue to report weaknesses we consider to be material as part of our annual audit Report(s) on Internal Control included in our Independent Auditors Report(s) on the DoD Agency-Wide Financial Statements and reports for the DoD Components. Our reports will also include comments regarding unsupported levels of assurance when appropriate. We made a minor change to our recommendation to ensure the Correction Target Dates in the Performance and Accountability Report are consistent with the latest reported target date from the Components' ASAs. The change recognizes an inconsistency is possible, but it should be adequately justified. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

Federal Managers' Financial Integrity Act (FMFIA) of 1982. In 1982, Congress passed the FMFIA,¹ which requires agencies to develop cost-effective internal accounting and administrative controls. These controls are intended to help ensure that an agency's:

- obligations and costs are in compliance with applicable law;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- revenues and expenditures applicable to agency operations are properly recorded and accounted for.

Section 2 of FMFIA requires the head of each agency to annually evaluate the agency's internal control and prepare an Annual Statement of Assurance (ASA) indicating the effectiveness of its internal control. The agency head must include in its ASA any identified material weaknesses in internal control as well as plans and schedules for correcting those weaknesses.

Section 4 of the FMFIA of 1982 requires that the head of each agency include a separate report on whether the agency's accounting system conforms to the principles, standards, and related requirements prescribed by the Comptroller General.

In addition, the FMFIA tasked the Government Accountability Office (GAO) and the Office of Management and Budget (OMB) to issue guidance to assist agencies in establishing, assessing, and reporting on internal controls.

GAO Guidance. In November 1999, GAO issued the revised "Standards for Internal Control in the Federal Government" ("Green Book"). The standards provide the overall framework for establishing and maintaining internal control, and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement. According to the Green Book, there are five standards for internal control that define the minimum level of quality acceptable for internal control in Government and provide a basis against which internal control is to be evaluated. These five standards for internal control are control environment, risk assessment, control activities, information and communications, and monitoring.

The standards view internal control as a major part of managing an organization and include plans, methods, and procedures used to meet missions, goals, and objectives, and, in doing so, support performance-based management. Further, internal control also serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud, and helps Government program managers achieve desired results through effective stewardship of public resources. Additionally, GAO issued the "Internal Control and Management Evaluation Tool" in 2001 to provide a systematic, organized, and structured approach to assessing the internal control structure.

¹ The key provisions of FMFIA were codified in section 3512 (c) and (d), title 31, United States Code.

OMB Guidance. OMB Circular A-123 Revised, “Management’s Responsibility for Internal Control,” December 21, 2004,² provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, correcting, and reporting on internal control. Agencies and individual Federal managers must take systematic and proactive measures to:

- develop and implement appropriate cost-effective internal control for results-oriented management,
- assess the adequacy of internal control in Federal programs and operations,
- separately assess and document internal control over financial reporting consistent with the process defined in Appendix A of OMB Circular A-123 Revised,
- identify needed improvements and take corresponding corrective action, and
- report annually on internal control through management assurance statements.

OMB Bulletin No. 06-03, “Audit Requirements for Federal Financial Statements,”³ establishes the minimum requirements for audits of Federal financial statements.

DoD Guidance. DoD Instruction 5010.40, “Managers’ Internal Control Program (MIC) Procedures,” as revised, was signed into effect on January 4, 2006, and is the official document for DoD compliance with the FMFIA and OMB Circular A-123. DoD Instruction 5010.40 sets forth the responsibilities of the Under Secretary of Defense (Comptroller)/Chief Financial Officer (USD[C]) with regard to implementing its program.⁴

ASAs in DoD. To satisfy the reporting requirement of FMFIA, DoD prepares an ASA to report on whether the agency’s internal control is effective and achieving the intended objectives in accordance with established guidelines and standards, using information from the DoD Components. The ASA is included in the DoD annual Performance and Accountability Report (PAR).

² We used the revised OMB Circular A-123 for the FY 2006 analysis, and the June 21, 1995, version for our analysis of FY 2005 data. With the exception of the Appendix A requirements in the revised Circular, which were not included in our audit, the general requirements of the revised OMB Circular A-123 and the 1995 version are substantially the same.

³ OMB Bulletin No. 06-03 was signed into effect on August 23, 2006, and we used it in our analysis of the FY 2006 data. This bulletin superseded OMB Bulletin No. 01-02, October 16, 2000, and related technical amendments, which we used for our analysis of FY 2005 data. However, the requirements of both bulletins pertaining to audit procedures on FMFIA are substantially the same.

⁴ We used DoD Directive 5010.38, “Management Control Program,” August 26, 1996, for our analysis of the FY 2005 data. DoD canceled this Directive on January 4, 2006. Therefore, we did not use this bulletin for our analysis of FY 2006 data.

Process for Preparing DoD ASA. The USD(C) is responsible for preparing the DoD ASA for submission to the President and Congress. To prepare the DoD ASA included in the PAR, USD(C) requires ASAs from the heads of each DoD Component. For FY 2005, 32 DoD Components submitted ASAs to USD(C) and for FY 2006, 34 DoD Components submitted ASAs. For both FYs 2005 and 2006, USD(C) personnel consolidated the “feeder” ASAs from DoD Components to prepare and support the DoD ASA (see Appendix B for a list of these Components).

DoD considers material weaknesses from the Components’ ASAs when preparing the DoD Agency-Wide ASA. Specifically, new material weaknesses identified by a Component become material weaknesses on the DoD ASA and new weaknesses related to one of the existing systemic weaknesses are consolidated. When preparing the DoD Agency-Wide ASA, USD(C) personnel do not report new weaknesses that are corrected within the same year they are identified.

Process for Preparing DoD Components’ ASA. The DoD Components’ ASAs are based on the senior management assessments of the effectiveness of their internal controls. The Components have designated offices responsible for managing the ASA reporting process, which require supporting statements of assurance from their reporting organizations, reporting elements, or assessable units. A Component’s designated office consolidates the supporting statements of assurance into one ASA that represents the Component as a whole. The ASA is submitted to the head of the Component for review and signature.

Objectives

Our overall audit objective was to determine whether DoD complies with the FMFIA. Specifically, we assessed whether the FY 2005 and FY 2006 ASAs for DoD and selected DoD Components complied with the requirements of FMFIA and subsequent implementation guidance in OMB Circular A-123. See Appendix A for a discussion of the scope and methodology, and prior coverage related to the objectives. (Our announced objective dealt with FY 2005 data; however, we included our analysis of FY 2006 data in this report.)

Compliance with Federal Managers’ Financial Integrity Act of 1982

The DoD and Military Departments’ ASAs were not always complete and may contain inaccurate information because DoD:

- did not fully consider all sources of information in identifying and reporting material weaknesses,
- provided a level of assurance on internal control over financial reporting that was not consistent with the scope and pervasive nature of the DoD known material weaknesses, and
- reported target correction dates for its systemic weaknesses that are not supported by the Components’ ASAs.

As a result, DoD managers may not be able to effectively monitor and report on the status of material weaknesses, take timely action to correct internal control deficiencies, and meet the intent of the FMFIA and OMB Circular A-123.

Inaccurate and Incomplete Identification and Reporting of Material Weaknesses

The Military Departments did not identify and report several known, existing material weaknesses in financial management in their FY 2005 and FY 2006 ASAs, even though DoD previously acknowledged and DoD Inspector General (DoD IG) Independent Auditor’s Reports (IAR) included these material weaknesses. DoD and its Components had not considered all sources of information on material weaknesses in preparing their ASAs. Consequently, the Military Departments’ and the DoD Agency-Wide ASAs may contain inaccurate and incomplete information on material weaknesses.

OMB Circular A-123 requires that an agency head’s assessment of internal control be performed using a variety of informational sources including DoD IG and GAO reports, and audits of financial statements conducted pursuant to the Chief Financial Officers Act, as amended. For FMFIA reporting, OMB Circular A-123 defines a material internal control weakness as a deficiency that the agency head determines to be significant enough to be reported outside the agency. DoD Instruction 5010.40 states that the required DoD Components may identify internal control weaknesses through a variety of objective sources, including but not limited to: audits, inspections, investigations, management assessments, creditable information of nongovernmental origin, staff meetings, and management control evaluations. Any open findings agreed to by management are candidates for a material weakness at the applicable level until all corrective actions are complete.

However, USD(C) personnel preparing the DoD ASA do not validate the completeness and accuracy of individual Components' ASAs or verify whether the Components considered all sources of information in preparing these ASAs. This occurs because each Component is ultimately responsible and accountable for its assurances and its program design, direction, and implementation.

OMB Bulletin No. 06-03 also requires that the auditor's report on internal control identify material weaknesses discovered that were not reported in the reporting entity's ASA. Such auditor-discovered weaknesses not detected and reported by management on the ASA could be a reportable condition or material weakness in the entity's internal control.

Review of FY 2005 Data. As part of our review of the FY 2005 ASA for DoD and DoD Components, we compared the FY 2005 ASAs to the FY 2004 IARs⁵ and identified several material weaknesses⁶ reported on the IARs that the Army, Navy, and Air Force did not include in their ASAs. The IARs for the Military Departments showed material weaknesses in the following areas:

- Environmental Liabilities of \$40.4 billion for Army General Fund,
- Property, Plant, and Equipment of \$156 billion for Navy General and Working Capital Funds, and
- Operating Materials and Supplies of \$51.3 billion for the Air Force General Fund.

The Military Departments did not report these items as material internal control weaknesses in their respective ASAs.

Table 1 shows the material weaknesses identified in the FY 2004 DoD IG IARs but not identified or reported on the Departments of the Army, Navy, and Air Force FY 2005 ASAs.

⁵ Because the FY 2005 IARs were issued after the Military Departments submitted their FY 2005 ASAs, we used the FY 2004 IARs, which allowed adequate time for each Military Department to consider weaknesses from the FY 2004 IAR and include them in their respective ASAs. All material weaknesses identified in the FY 2004 IAR were also identified on the FY 2005 IAR except for these Air Force items pertaining to FY 2004 General Property, Plant, and Equipment; Policies and Practices; and In-Transit Inventory.

⁶ If the Military Departments reported the IAR material weakness in its ASA as a material weakness, area of concern, or a reportable condition, we considered this a satisfactory indication that the Military Departments considered the weakness significant enough to warrant the attention of a higher-level management. This applied to our review of both FY 2005 and 2006 ASAs.

Table 1. Comparison of Auditor Identified and DoD Military Departments' Reported Material Weaknesses for FY 2005

Material Weaknesses in Internal Controls	Army		Navy		Air Force	
	Identified in the DoD IG FY 2004 IAR	Included in the Army FY 2005 ASA	Identified in the DoD IG FY 2004 IAR	Included in the Navy FY 2005 ASA	Identified in the DoD IG FY 2004 IAR	Included in the Air Force FY 2005 ASA
Financial Management Systems	YES	NO	YES	NO	YES	NO
Fund Balance with Treasury	YES	NO	YES	NO		
Inventory	YES	NO	YES	YES		
Operating Materials and Supplies					YES	NO
General Property, Plant, and Equipment	YES	YES	YES	YES	YES	NO
Environmental Liabilities	YES	NO	YES	YES	YES	NO
Intragovernmental Transactions	YES	NO			YES	NO
Other Accounting Entries					YES	NO
Abnormal Account Balances	YES	NO				
Accounts Receivable	YES	NO	YES	NO		
Accounts Payable	YES	NO	YES	YES		
Policies and Practices					YES	NO
Other Liabilities--Unsupported, Undistributed, Problem Disbursements			YES	NO		
Accounting Adjustments	YES	NO				
In-Transit Inventory					YES	NO
Total Internal Control Weaknesses	10	1	8	4	8	0

Review of FY 2006 Data. Effective FY 2006, the new Appendix A requirements in OMB Circular-123 Revised requires an assurance statement on the internal control over financial reporting in the annual PAR. We did not review DoD compliance with OMB Circular A-123, Appendix A because this is a new requirement and DoD had adopted a phased implementation. However, we identified several material weaknesses reported on the FY 2005 IARs that were not included on the FY 2006 Navy and Air Force ASAs.⁷ The IARs for the Military Departments showed material weaknesses in the following areas:

- Financial Management Systems used by the Navy have significant weaknesses and do not fully comply with all requirements of the Federal Financial Management Improvement Act of 1996, and
- Operating Materials and Supplies of \$47.2 billion for the Air Force General Fund.

⁷ Because the FY 2006 IARs were issued after the Military Departments submitted their FY 2006 ASAs, we used the FY 2005 IARs, which allowed adequate time for each Military Department to consider weaknesses from the FY 2005 IAR and include them in their respective ASA.

However, the Military Departments did not report these items on their ASAs as material weaknesses. Table 2 shows the material weaknesses identified by the DoD IG FY 2005 IAR and weaknesses reported on the Departments of the Army, Navy, and Air Force FY 2006 ASAs.

Material Weaknesses in Internal Controls	Army		Navy		Air Force	
	Identified in the DoD IG FY 2005 IAR	Included in the Army FY 2006 ASA	Identified in the DoD IG FY 2005 IAR	Included in the Navy FY 2006 ASA	Identified in the DoD IG FY 2005 IAR	Included in the Air Force FY 2006 ASA
Financial Management Systems	YES	YES	YES	NO	YES	NO
Fund Balance with Treasury	YES	YES	YES	YES		
Inventory	YES	YES	YES	YES		
Operating Materials and Supplies					YES	NO
General Property, Plant, and Equipment	YES	YES	YES	YES		
Environmental Liabilities	YES	YES	YES	YES	YES	NO
Intragovernmental Transactions	YES	YES			YES	NO
Other Accounting Entries					YES	NO
Abnormal Account Balances	YES	YES				
Accounts Receivable	YES	YES	YES	YES		
Accounts Payable	YES	YES	YES	YES		
Problem Disbursements			YES	NO		
Accounting Adjustments	YES	YES				
Total Internal Control Weaknesses	10	10	8	6	5	0

We fully understand that a weakness is considered material if the head of the DoD Component determines that the weakness is significant enough to be reported outside the Component and that, ultimately, the decision of whether a weakness is “material” is leadership’s judgment. However, in our opinion, these financial statement material weaknesses shown on Tables 1 and 2 are so significant that excluding them from the relevant Military Department’s ASA misrepresented the status of material weaknesses required to be reported by FMFIA.

Identifying and Reporting Internal Control Weaknesses. The following paragraphs explain the Army, Navy, and Air Force processes for identifying and reporting internal control weaknesses.

Army Process. Internal control personnel explained that the initial determination of whether an internal control weakness is material can be made at any level or command. If the weakness is considered material and is reported, each successive level of command re-evaluates the weakness to determine if it is material. Army uses external sources such as DoD IG reports for its overall evaluation.

Navy Process. Internal control personnel explained that Navy self-reports its control deficiencies. This allows commands to demonstrate their control environments and activities, and indicate the findings of their control assessments. In addition to self-reporting control deficiencies, Navy uses audit reports from the GAO, DoD IG, and Naval Audit Service to help identify material control deficiencies throughout the year. Additionally, Naval Audit Service reviews audit reports on a quarterly basis and uses a systematic method to determine materiality and potential inclusion of weaknesses in the Navy ASA.

Air Force Process. Internal control personnel stated that the Air Force Auditor General provides an annual Internal Control Assessment to the Secretary of the Air Force that includes a synopsis of the most significant issues uncovered during the year, and recommends strong consideration be given to reporting those issues as possible material weaknesses. These issues are generally based on GAO, DoD IG, and Air Force Audit Agency audit reports reviewed during the year. These issues are sent to responsible functional offices for consideration, who are then required to respond whether they will report or why they should not.

Although the Army, Navy, and Air Force internal control personnel explained they considered material weaknesses identified by the external sources such as GAO and DoD IG reports, Tables 1 and 2 show that the Air Force and Navy do not always include such material weaknesses in their ASAs. The Army's FY 2006 ASA included all of the weaknesses identified in the IAR.

Unsupported Qualified Statement of Reasonable Assurance

FMFIA requires the Secretary of Defense to submit an annual statement to Congress and the President on whether there is reasonable assurance that the agency's internal controls are achieving their intended objectives. OMB Circular A-123, implementing FMFIA, states that this ASA represents the agency head's informed judgment as to the overall adequacy and effectiveness of internal control within the agency. The agency must provide one of the following levels of assurance: unqualified statement of assurance, qualified statement of assurance, or a statement of no assurance. To determine the type of assurance to provide, OMB Circular A-123 requires that the agency head consider information from DoD IG and GAO reports, audits of financial statements conducted pursuant to the Chief Financial Officers Act of 1990, and other sources. Additionally, the agency head must describe the analytical basis for the type of assurance provided and the extent to which agency activities were assessed.

Table 3 provides a summary of the OMB Circular A-123 guidance on the appropriate levels of assurance.

Table 3. OMB A-123 Guidance on Level of Assurance	
If agency has...	agency's level of assurance should be...
No Material Weaknesses	Unqualified
One or More Material Weaknesses	Qualified
No Process in Place or Pervasive Material Weaknesses	No Assurance

GAO Reports and Testimonies on DoD Weaknesses. For 16 years, GAO has continually reported that weaknesses in business management systems, processes, and internal control adversely affect 1) the reliability of reported financial data and 2) the management of DoD operations. According to GAO, “DoD’s financial management problems are pervasive, complex, long-standing, deeply rooted in virtually all of its business operations, and challenging to resolve.”⁸ The nature and severity of DoD financial management, business operations, and system deficiencies affects financial reporting and impedes DoD managers’ ability to obtain all necessary information to effectively manage operations. Such weaknesses have negatively impacted DoD’s ability to control costs, ensure basic accountability, anticipate future costs and claims on the budget, measure performance, maintain funds control, and prevent fraud.

GAO has reported that the “DoD financial management deficiencies, taken together, continue to represent the single largest obstacle to achieving an unqualified opinion on the U.S. Government’s consolidated financial statements.” According to GAO, the long-standing inability of any Military Service or major Defense Component to pass an independent financial audit because of pervasive weaknesses in financial management systems, operations, and controls provides additional evidence of DoD’s problems. GAO further states that “these pervasive financial and business management problems adversely affect the economy, efficiency, and effectiveness of operations, and have resulted in a lack of adequate accountability across all major business areas.”

FY 2006 Requirement for a Statement of Assurance on Internal Control over Financial Reporting. The December 2004 revision to OMB Circular A-123 added a new requirement for agencies to provide a separate statement of assurance on the effectiveness of internal control over financial reporting as a subset of the overall ASA. DoD has adopted an incremental approach for implementing this requirement by looking at specific focus areas each year—eight reporting areas for FY 2006, and twelve areas for FY 2007. In the FY 2006 PAR, the Deputy Secretary of Defense provided a “qualified” statement of assurance over areas reviewed, and no assurance on the areas not reviewed. We realize that the FMFIA and OMB Circular A-123 state that the head of each agency has the responsibility of determining whether a weakness is material

⁸ GAO Testimony before the Subcommittee on Government Management, Finance, and Accountability, Committee on Government Reform, House of Representatives – Reports: GAO-06-1006T (August 3, 2006), GAO-06-406T (March 1, 2006), and GAO-05-520T (April 13, 2005).

enough to be reported on the ASA and providing the agency's level of assurance. However, we consider it our responsibility as auditors to provide feedback on the validity of management's level of assurance on internal control over financial reporting.

We did not perform an in-depth review of the process used by DoD management to assess the effectiveness of internal controls over financial reporting as required by OMB A-123, Appendix A. However, the DoD consolidated financial statements and those of the consolidating Military Departments have never passed an independent audit of their financial statements, and DoD financial management systems do not meet any of the three requirements of the Federal Financial Management Improvement Act. Consequently, in our opinion, the DoD weaknesses in financial management do not support a qualified assurance on the effectiveness of these controls.

We continue to support the disciplined approach personnel from the Office of the USD(C) are taking to help all DoD Components comply with the requirements of the revised OMB Circular A-123. DoD continues to make progress in correcting the long-standing and pervasive weaknesses in financial management throughout the Department. However, we consider the qualified statement of assurance for the internal control over financial reporting to be misleading because a qualified statement of assurance does not accurately reflect the results of the assessments that DoD conducted in order to meet the requirement in Appendix A. A statement of no assurance would be more appropriate because:

- pervasive material internal weaknesses in financial reporting continue to exist,
- management acknowledged that DoD's financial statements do not conform to generally accepted accounting principles, and
- DoD financial management system deficiencies continue to exist.

A statement of no assurance on the internal controls over financial reporting would reflect more clearly the level of assurance that management can provide considering the pervasive material weaknesses that affect the reliability of the DoD financial statements. We included this conclusion in our FY 2006 Report on the DoD Agency-Wide Financial Statements,⁹ but did not make any recommendations.

A qualified level of assurance may be acceptable for the overall ASA for DoD and its Components based on a careful evaluation of all weaknesses. However, in our opinion, DoD does not have an adequate basis for giving a qualified opinion on the effectiveness of internal control over financial reporting as long as the current weaknesses continue to exist. Based on additional audit work to produce this audit report, we are recommending that DoD include a statement of no assurance on the internal controls over financial reporting.

⁹ DoD IG Report D-2007-020, "Independent Auditor's Report on the Fiscal Year 2006 Department of Defense Agency-Wide Financial Statements," November 12, 2006.

Inconsistent and Unsupported Correction Target Dates

DoD reported target correction dates that were not consistent with or supported by the DoD Component level ASAs. Specifically, the Office of the Secretary of Defense (Acquisition, Technology, and Logistics) reported target correction dates for systemic weaknesses that did not represent the Components' target dates.

Target correction dates represent the DoD timeline for resolution of identified material weaknesses. For a DoD Agency-Wide weakness, this date represents a roll-up of the dates on which the DoD Components who contribute to that weakness expect to resolve their individual portion of the weakness. Consequently, when all the individual Components contributing to that weakness each correct their portion of that weakness, the systemic weakness will be corrected. Therefore, the target correction date would be the date when the DoD Component with the latest target date was able to correct its weaknesses.

However, the DoD FY 2006 ASA¹⁰ reported earlier target correction dates than those reported by the Components. As a result, the FY 2006 DoD ASA contains unsupported target correction dates. Unsupported target correction dates lead to inaccurate conclusions on the agency's progress correcting the material weaknesses and may impair management's judgment as to the severity of the underlying weakness. Additionally, unsupported target correction dates provide unrealistic expectations for the resolution of pervasive weaknesses and potentially deny the agency of resources needed to correct long standing material weaknesses.

Table 4 shows FY 2006 correction target dates that were not supported by the Component-level dates as shown in their ASAs.

¹⁰ FY 2005 DoD ASA target dates were also incorrect. For example, one Component listed its correction target date for Valuation of Inventory on Financial Reports as 4th quarter FY 2011, while the DoD correction target date was shown as 3rd quarter FY 2006. That same Component listed its target correction date for Valuation of Property, Plant, and Equipment as 1st quarter FY 2008, while DoD gave 4th quarter FY 2006 as the date.

Table 5. FY 2006 Component Correction Target Dates

DoD Overall Systemic Weakness	DoD Correction Target Dates	Feeder Components' Statements of Assurance	Component Correction Target Dates
Management of Information Technology and Assurance	3rd quarter FY 2007	Office of the Secretary of Defense	4th quarter FY 2007
		Navy	1st quarter FY 2008
		National Defense University	4th quarter FY 2008
		Air Force	3rd quarter FY 2008
		Defense Security Cooperation Agency	1st quarter FY 2008
Personnel Security Investigations Program	4th quarter FY 2007	Navy	1st quarter FY 2008
Department of Defense Contracting for Services	4th quarter FY 2007	Army	4th quarter FY 2010
		Defense Finance and Accounting Service	4th quarter FY 2008

OMB Circular A-123 states that correcting deficiencies is an integral part of management accountability and must be considered a priority by the agency. OMB Circular A-123 also requires that the agency's summary of the corrective action plans for material weaknesses to be included in the agency's PAR and include a description of the material weakness, status of corrective actions, and timeline for resolution.

In addition, OMB Circular A-123 requires management to maintain accurate records of the status of the identified material weaknesses as part of its process for resolution and corrective action of identified material weaknesses in internal control. Consistent and supportable target correction dates will assist DoD in fully satisfying this requirement.

Recommendations, Management Comments, and Audit Response

We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer, in coordination with the Military Departments and Defense agencies:

- 1. Revise the annual guidance on preparing the Annual Statement of Assurance to require Components to provide thorough documentation on the**

reasons for excluding the material weaknesses in financial reporting identified by the DoD Inspector General and Government Accountability Office reports.

Management Comments. The Acting Deputy Chief Financial Officer concurred in principle. The FY 2006 guidance for preparing the Annual Statement of Assurance states that DoD Components must ensure that sufficient documentation is retained to explain significant decisions made in determining which weaknesses to report outside the entity. Determination whether a weakness is material is a management decision, and there is no requirement that a DoD Component has to report a FMFIA material weakness based on a material weakness reported by auditors.

Auditor Response. We accept management's response. However, we are disappointed that management comments appeared to emphasize the fact that it is a management decision on whether to report material internal control weaknesses. As part of its oversight role, we would hope that personnel from the Office of the USD(C) would seriously question a DoD Component that did not report a material weakness auditors identified when the weakness relates to a line item that is significant to the Component. The report gave specific examples of material internal control weaknesses, some of which related to material line items on the annual financial statements that DoD Component management decided not to report. We will continue to report weaknesses we consider to be material in our annual audit Report(s) on Internal Control as part of our Independent Auditors Report(s) on the DoD and its Components. We also will highlight such examples when considered appropriate.

2. Provide a statement of no assurance on internal control over financial reporting for the DoD as long as significant and multiple pervasive weaknesses continue to exist.

Management Comments. The Acting Deputy Chief Financial Officer concurred in principle and stated that DoD is implementing an incremental approach in complying with the requirements of Appendix A of OMB Circular A-123. For FY 2006, management focused only on providing an assessment for the following eight areas: Fund Balance with Treasury, Investments, Real Property, Military Equipment, Federal Compensation Act Liabilities, Environmental Liabilities, Medicare-Eligible Retiree Health Care Liabilities, and Appropriations Received. After reviewing these areas, DoD reported material weaknesses for five of these areas. He further stated that for the FY 2006 Statement of Assurance, the Deputy Secretary of Defense provided a "qualified statement of reasonable assurance over financial reporting for a limited number of focus areas, and no assurance outside these areas."

Auditor Response. We accept management's response because the determination of the level of assurance is a management decision according to the FMFIA and OMB Circular A-123. However, providing a "qualified statement of assurance on its internal management controls over financial reporting" is misleading in our opinion. The FY 2006 PAR showed material weaknesses for five of the eight financial reporting areas that DoD reviewed. In our opinion, it would have been more appropriate to say that DoD could provide no assurance on five of the eight areas related to financial reporting that had specific material internal control weaknesses. Our FY 2006 Independent Auditors' Report on the

DoD Agency-Wide Financial Statement stated that we considered a qualified statement of assurance for internal controls over financial reporting to be misleading. We will continue to provide similar conclusions when we consider management conclusions to be misleading.

3. Revise the dates reported in the Performance and Accountability Report as the “Correction Target Dates” to be consistent with the latest reported target date from the Components’ Annual Statements of Assurance, or ensure that the reason for any inconsistency can be fully justified.

Management Comments. The Acting Deputy Chief Financial Officer concurred in principal, but suggested that we change the wording in the recommendation to say that management should review the dates reported in the PAR and ensure any inconsistencies can be reasonably justified. He further stated that the USD(C) has already requested additional information from the Principal Staff Assistants having oversight of the areas where date differences occurred. This information will help personnel preparing the PAR gain a better understanding of why the differences exist and be better able to address the differences in the future.

Audit Response. We consider the comments responsive to the recommendation. We agree that inconsistencies in the Correction Target Dates could be possible and have slightly revised the recommendation. However, justification of inconsistencies related to the final correction date of material weaknesses of major DoD Components is not probable. As part of our review of future PARs, we will continue to evaluate any justification for Correction Target Dates that are not consistent with the latest reported target date from the Components’ Annual Statements of Assurance.

Appendix A. Scope and Methodology

We reviewed the FY 2005 and FY 2006 ASAs for DoD and selected Components to determine if they complied with FMFIA, as codified in section 3512 (c) and (d), title 31, United States Code. The initial audit approach, which was based on a preliminary understanding of the DoD FMFIA reporting structure, was to review one Component from each stratum of the DoD organizational structure, as follows:

- Department of Army (Military Service),
- TRICARE (Office of the Secretary of Defense Field Activity),
- Defense Logistics Agency (DLA) (Defense Agency)
- United States Special Operations Command (SOCOM) (Unified Combatant Command)

In the course of the audit, we determined that DLA, TRICARE, and SOCOM were not material to the DoD Agency-Wide financial statements. Because the audit was in support of the DoD Agency-Wide financial statement audit, we revised our scope to include significant consolidating Components, namely, Army, Navy and Air Force. These Components made up nearly 70 percent of the DoD combined FY 2005 assets. Though we reviewed TRICARE and SOCOM, but not DLA, we determined that the results of these reviews would not be material to DoD.

Because our initial audit objective included an assessment of controls pertaining to the reporting process and a determination as to whether the ASA for DoD and selected Components met the FMFIA requirements, we performed limited top-down and bottom-up reviews of the organizations. We reviewed Federal laws, OMB guidance, DoD Directives and Instructions, and internal policies of the Army, Navy, and Air Force. We also reviewed the FYs 2004 and 2005 DoD PAR, the FYs 2004 and 2005 IARs, and the FYs 2005 and 2006 ASAs for the Army, Navy, and Air Force to identify the material weaknesses disclosed in DoD IG IAR and DoD Components ASA, respectively. We visited, contacted, and conducted interviews with officials from USD(C), Army, Navy, and Air Force to gain information on their process for identifying, reporting, and correcting material weaknesses.

We performed this audit from January 2006 through February 2007 in accordance with generally accepted government auditing standards.

Use of Computer-Processed Data. We did not rely on computer-processed data to perform this audit.

GAO High-Risk Area. GAO has identified several high-risk areas in DoD. This report provides coverage of the Financial Management high-risk area.

Prior Coverage

During the last 5 years, the GAO and the DoD IG have issued several reports/testimony related to DoD policies and procedures for the Federal Managers' Financial Integrity Act of 1982. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov/>. Unrestricted IG DoD reports can be accessed at <http://www.dodig.mil/audit/reports>.

GAO

GAO Testimony No. GAO-06-1006T, "Sustained Leadership Is Critical to Effective Financial and Business Management Transformation," August 3, 2006

GAO Testimony No. GAO-06-497T, "GAO's High Risk Program," March 15, 2006

GAO Testimony No. GAO-06-406T, "Fiscal Year 2005 U.S. Government Financial Statements Sustained Improvement in Federal Financial Management is Crucial to Addressing Our Nation's Financial Condition and Long-term Fiscal Imbalance," March 1, 2006

GAO Testimony No. GAO-05-520T, "DoD's High-Risk Areas Successful Business Transformation Requires Sound Strategic Planning and Sustained Leadership," April 13, 2005

DoD IG

DoD IG Report No. D-2005-025, "DoD FY 2004 Implementation of the Federal Information Security Management Act for Information Technology Training and Awareness," December 17, 2004

DoD IG Report No. D-2005-017, "Independent Auditor's Report on the FY 2004 DoD Agency-Wide Financial Statements," November 12, 2004

DoD IG Report No. D-2006-022, "Independent Auditor's Report on the FY 2005 DoD Agency-Wide Financial Statements," November 12, 2005

Appendix B. DoD Components Providing Annual Statements of Assurance

The following DoD Components provided ASAs to the USD(C) to support the FY 2005 and FY 2006 DoD ASAs:

- Office of the Secretary of Defense (consolidated Office of the Secretary of Defense Principal Staff Assistants and DoD Field Activities Prepared by the Director of Administration and Management)
- Department of the Army
- Department of the Navy
- Department of the Air Force
- Joint Staff
- United States European Command
- North American Aerospace Defense/United States Northern Command
- United States Transportation Command
- United States Pacific Command
- United States Southern Command
- United States Joint Forces Command
- United States Central Command
- United States Special Operations Command
- United States Strategic Command
- Inspector General Department of Defense
- Defense Advanced Research Projects Agency
- Defense Commissary Agency
- Defense Contract Audit Agency
- Defense Contract Management Agency
- Defense Finance and Accounting Service
- Defense Information Systems Agency

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- Defense Intelligence Agency
 - Defense Logistics Agency
 - Defense Security Cooperation Agency
 - Defense Security Service
 - Defense Threat Reduction Agency
 - Missile Defense Agency
 - National Defense University
 - National Geospatial-Intelligence Agency
 - National Security Agency/Central Security Service
 - Pentagon Force Protection Agency
 - Uniformed Services University of the Health Sciences
 - Defense Business Transformation Agency (added for FY 2006)
 - Department of Defense Financial Reporting (added for FY 2006)

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Combatant Commands

Commander, U.S. Special Operations Command

Other Defense Organizations

Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
Director, TRICARE

Non-Defense Federal Organization

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations

Senate Committee on Armed Services
Senate Committee on Homeland Security and Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Subcommittee on Government Management, Organization and
Procurement
House Committee on Oversight and Government Reform
House Subcommittee on National Security and Foreign Affairs

Under Secretary of Defense (Comptroller)/Chief Financial Officer Comments



COMPTROLLER

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

MAY 1 2007

MEMORANDUM FOR ACTING INSPECTOR GENERAL, DEPARTMENT OF
DEFENSE

SUBJECT: Draft Audit Report, DoD Compliance with the Federal Managers' Financial
Integrity Act of 1982 (Project No. D2006-D000FA-0106.000)

This memorandum is in response to the subject draft report provided to this office
for review and comment. Our response to each of the audit report recommendations is
attached.

We appreciate the opportunity to respond to your draft audit report and look
forward to resolving the cited issues. My point of contact is Mr. Jerry Hinton. He can be
reached by telephone at (703) 602-0300 x121 or email at jerry.hinton@osd.mil.

A handwritten signature in black ink, appearing to read "Robert P. McNamara".

Robert P. McNamara
Acting Deputy Chief Financial Officer

Attachment:
As stated

DEPARTMENT OF DEFENSE INSPECTOR GENERAL
DRAFT REPORT D2006-D000FA-0106.000

Agency Comments on Draft Report, "DoD Compliance with the Federal Managers' Financial Integrity Act (FMFIA) of 1982"

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)
COMMENTS

Recommendation 1: We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer, in coordination with the Military Departments and Defense agencies:

1. Revise the annual guidance on preparing the Annual Statement of Assurance to require Components to provide thorough documentation on the reasons for excluding the material weaknesses in financial reporting identified by the Inspector General, DoD and Governmental Accountability Office reports.

OUSDC(C) Response: Concur in principle. Our guidance specifies requirements for documenting the determination for reporting material weaknesses. For example, Fiscal Year (FY) 2006 Guidance for the Preparation of the Statement of Assurance, dated Nov 8, 2005, Part 2, Page 16 of 44, paragraph 2 states that DoD Components, "...must ensure that sufficient documentation is retained to explain significant decisions made in identifying material business process, results of the assessments, internal control test plans, and in determining which weaknesses to report outside the entity." In light of this, I view this recommendation as closed.

The determination of the materiality of a weakness is a management decision. Once the information from various sources (FMFIA reviews, audits, etc.) is reviewed, management determines whether or not they have a material weakness. Although management should consider material weaknesses reported by an independent auditor when determining its own reporting under FMFIA, just as management should consider results of other internal controls reviews performed within the Department, there is no requirement that a DoD Component or Agency Head has to report a FMFIA material weakness based on a material weakness reported by an independent auditor.

Recommendation 2: Provide a statement of no assurance on internal control over financial reporting for the DoD as long as significant and multiple pervasive weaknesses continue to exist.

OUSD(C) Response: Concur in principle. In FY 2006, the Department completely revised its official policy and guidance to be in line with the Office of Management and Budget (OMB) Circular A-123, Appendix A. The Department's policy for FY 2006 is provided in Department of Defense Instruction 5010.40, Managers' Internal Control Program Procedures, January 4, 2005, and the annual guidance, FY 2006 Guidance for the Preparation of the Statement of Assurance, November 8, 2005. The Department's guidelines are in line with the intent of the OMB Circular A-123, Appendix A, which calls for managers to perform an end-to-end review of its processes, identify risks and conduct tests of its controls, in order to identify problems and implement corrective actions. Material weaknesses will be reported based on managers' assessment work.

The Department's guidelines implement an OMB approved incremental approach to the OMB Circular A-123, Appendix A, as discussed on page 15 of the Performance and Accountability Report (PAR), dated November 15, 2006. The focus areas for which management conducted an Appendix A assessment using the strict application of the annual guidance, Part II, were limited to: Fund Balance with Treasury, Investments, Real Property, Military Equipment, Federal Employee Compensation Act Liabilities, Environmental Liabilities, Medicare-Eligible Retiree Health Care Liabilities, and Appropriations Received. See page 14 of the DoD Performance and Accountability Report, dated November 15, 2006. After a review of these areas, the Department reported five material weaknesses as listed on pages 193-197 in Table VI, those weaknesses and the representative percentage of the balance sheet are: Valuation of Military Equipment Assets (26.7%), Valuation of Real Property Assets (7.8%), Reporting of Environmental Liabilities (3.5%), Reporting of Defense Health Care Liabilities (28.7%), and Fund Balance with Treasury (22.8%). The Department reported no assurance outside these areas because no OMB Circular A-123, Appendix A management assessment was conducted outside these areas.

In FY 2006, the Department collected documentation to support management's level of assurance on internal control over financial reporting. Because of the incremental implementation approach and limited scope of the first year of implementation, the Department determined that it would render a level of assurance for the focus areas within the scope and no assurance for financial areas not within the scope. Those weaknesses previously reported as financial but not within the Appendix A scope will remain in the overall A-123 scope until such time as they are included in a successive increment. In that way, the Department would be assured that it had the appropriate supporting documentation required by Appendix A.

The determination for the level of assurance is management's judgment, under the FMFLA and the OMB Circular A-123. In our FY 2006 Statement of Assurance, signed by the Deputy Secretary of Defense, the Department provided a *qualified statement of reasonable assurance over financial reporting for a limited number of focus areas, and no assurance outside these areas*. I consider the level of assurance that the Department

Revised

expressed in FY 2006 to be representative and in line with the incremental approach that the Department decided to implement under the oversight of the senior level DoD Senior Assessment Team. As a result, I consider this recommendation closed.

Recommendation 3: Revise the dates reported in the PAR as the “Target Correction Dates” to be consistent with the latest reported target date from the Components’ Annual Statement of Assurance.

OSD(C) Response: Concur in principle. I suggest the recommendation should be changed to, “Review the dates reported in the PAR as the ‘Target Correction Dates’ and ensure that the reason for inconsistency can be reasonably justified.” In the spirit of this restated recommendation, the USD(C) signed memoranda to the Principal Staff Assistants having oversight of the areas where date differences occurred. In this correspondence, we requested additional information as to why there were date variances so that we could gain a better understanding of why the situation existed and to better prepare us to address this issue in the future.

Team Members

The Department of Defense Office of the Deputy Inspector General for Auditing, Defense Financial Auditing Service prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

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Inspector General
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