Audit Report

OFFICE OF THE INSPECTOR GENERAL

DEFENSE FINANCE AND ACCOUNTING SERVICE WORK ON THE FY 1993 AIR FORCE DEFENSE BUSINESS OPERATIONS FUND FINANCIAL STATEMENTS

Report No. 95-072 January 11, 1995

Department of Defense

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Acronyms

AFAA	Air Force Audit Agency
AMC	Air Mobility Command
CFO	Chief Financial Officer
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
FASAB	Federal Accounting Standards Advisory Board
IG	Inspector General
GAO	General Accounting Office
MAJCOM	Major Command
OMB	Office of Management and Budget

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

January 11, 1995

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Audit Report on Defense Finance and Accounting Service Work on the FY 1993 Air Force Defense Business Operations Fund Financial Statements (Report No. 95-072)

We are providing this final report for your review and comments. This audit was a part of our overall effort to fulfill the requirements of the Chief Financial Officers Act of 1990. Management comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. We deleted three recommendations from the draft report and added two recommendations based on management's comments. We request that you provide comments on the new recommendations by March 13, 1995. See the chart at the end of the finding for the specific requirements for your comments. Recommendations are subject to mediation in accordance with DoD Directive 7650.3 in the event of nonconcurrence or failure to comment.

The courtesies extended to the audit staff are appreciated. If you have any questions about this audit, please contact Mr. David C. Funk, Audit Program Director, at (303) 676-7445 (DSN 926-7445), or Mr. Thomas J. Winter, Audit Project Manager, at (303) 676-7416 (DSN 926-7416). Copies of the report will be distributed to the organizations listed in Appendix D. The audit team members are listed inside the back cover.

David K. Steensma

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Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Audit Report No. 95-072 **January 11, 1995**
(Project No. 3FD-2041)

DEFENSE FINANCE AND ACCOUNTING SERVICE WORK ON THE FY 1993 AIR FORCE DEFENSE BUSINESS OPERATIONS FUND FINANCIAL STATEMENTS

EXECUTIVE SUMMARY

Introduction. The Chief Financial Officers Act of 1990 requires the Inspector General, DoD, or an independent auditor appointed by the Inspector General, DoD, to audit the financial statements of DoD activities. We delegated the Air Force portion of the audit of the FY 1993 financial statements of the Defense Business Operations Fund to the Air Force Audit Agency. We provided assistance to the Air Force Audit Agency through audit work at the Defense Finance and Accounting Service (DFAS) Denver Center. The Air Force Audit Agency considered our audit results for FY 1993 in formulating its audit opinions. For the FY 1993 audit, we assessed internal controls and compliance with laws and regulations on four asset accounts reported on the Air Force's Defense Business Operations Fund financial statements. The four accounts reviewed were Fund Balances with Treasury ($1.4 billion), Inventories Held for Sale ($30.9 billion), Inventories Not Held for Sale ($3.35 billion), and Property, Plant and Equipment ($1.5 billion). The DFAS Denver Center prepared five individual financial statements and a consolidated financial statement. Specifically, this report addresses the consolidation by the DFAS Denver Center of the financial information, adjustments, and reporting activities of the Defense Business Operations Fund business areas. The Air Force's financial statements were combined with other Military Departments' statements to produce the overall financial statements for the Defense Business Operations Fund.

Objective. Our original audit objective was to determine whether the Air Force Consolidated Defense Business Operations Fund financial statements, prepared by the DFAS Denver Center for FY 1993, were presented fairly in accordance with accepted accounting principles. The objective was revised to correspond with the incremental audit approach that DoD audit organizations were using for the Defense Business Operations Fund's financial statements. Using the incremental audit approach, we reviewed four major asset accounts for FY 1993. Our audit work complemented the Air Force Audit Agency's audit of the Air Force's Defense Business Operations Fund financial statements for FY 1993. Specifically, we performed the reviews and tests necessary to assess the accuracy of financial data, the adequacy of internal controls, and compliance with laws and regulations. We also evaluated procedures that the DFAS Denver Center used to prepare consolidated financial statements.

Audit Results. The DFAS Denver Center may not have prepared complete, accurate, and reliable Defense Business Operations Fund financial statements for the Air Force. The DFAS Denver Center used negative inventory account data of $300.5 million and negative Inventory in Transit data of $1.1 billion to compute the inventory balances on the financial statements without performing adequate research into the causes of the negative balances, which are illogical. Also, the DFAS Denver Center did not resolve negative Inventory in Transit data at the department level. As a result, the FY 1993 statements may not accurately represent the yearend financial position.

Internal Controls. Internal control procedures used by the DFAS Denver Center were not adequate to prevent material misstatements in the Air Force's Defense Business Operations Fund financial statements for FY 1993. Internal controls for the four account balances did not prevent the processing of incorrect data. See Parts I and II of this report for details of these internal control weaknesses. In compliance with the Office of Management and Budget Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, we evaluated the DFAS Denver Center's implementation of DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. The DoD Internal Management Control Program was in place, but internal control weaknesses existed that had not been formally reported.

Compliance with Laws and Regulations. The audit identified material instances of noncompliance with regulations. The accounting systems used for the Defense Business Operations Fund were not in compliance with the requirements of DoD Manual 7720.9-M, the "DoD Accounting Manual." Internal controls were not adequate to prevent the processing of negative amounts in the asset accounts. The disclosures associated with the financial statements were not in compliance with Office of Management and Budget Bulletin No. 93-02, "Form and Content of Agency Financial Statements," and DoD Directive 5010.38, "Internal Management Control Program." Because of these instances of noncompliance, the financial statements may not accurately represent the financial condition of the Air Force Defense Business Operations Fund.

Potential Benefits of Audit. Recommendations in this report, if implemented, will improve financial disclosure. Fiscal responsibility should improve when the DFAS Denver Center implements accounting systems that comply with DoD Manual 7720.9-M, the "DoD Accounting Manual," and establishes adequate internal controls, including a transaction-based general ledger. However, we could not quantify the potential benefits. See Appendix B for all benefits resulting from the audit.

Summary of Recommendations. We recommend that the Director, Defense Finance and Accounting Service, establish policies and procedures to identify, prioritize, and correct negative balances before including them in the financial statements, and improve disclosure of negative Inventory in Transit amounts.

Management Comments. Management concurred with our recommendations to identify negative asset balances and contact the field activities to correct negative account data. Management nonconcurred with the recommendation that questionable account balances be prioritized for review, indicating that all negative inventory balances should be corrected. Management nonconcurred with the three recommendations concerning negative Inventory in Transit amounts. See Part II for a discussion of management's responses, and Part IV for the full text of management's comments.

Audit Response. Based on management's comments on the draft report, we deleted the three recommendations addressing Inventory in Transit. Concerning Inventory in Transit, we added two recommendations to the final report for actions that can be taken at the DFAS Denver Center. We consider management's comments to be responsive to our other three recommendations. We request that the Director, Defense Finance and Accounting Service, provide comments on this report by March 13, 1995.

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This report was prepared by the Financial Management Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

Part I - Introduction

Background

Public Law 101-576, the Chief Financial Officers Act of 1990 (the CFO Act), requires the annual preparation and audit of Government financial statements. The Defense Finance and Accounting Service (DFAS) Denver Center was responsible for preparing the FY 1993 financial statements and consolidated financial statements for the Air Force Defense Business Operations Fund (DBOF) business areas. The business area statements include Supply Management, Distribution Depot, Base Support, Transportation, and Depot Maintenance. Those financial statements represent the Air Force component of the overall DBOF financial statements.

The Inspector General (IG), DoD, is required to audit the financial statements. However, the IG, DoD, may delegate this responsibility to an independent external auditor. The IG, DoD, delegated the responsibility for expressing an opinion on the FY 1993 Air Force DBOF financial statements to the Air Force Audit Agency (AFAA). The IG, DoD, audit plan, which AFAA is also using, states that a portion of the DBOF financial statements will be reviewed each fiscal year. Four accounts on the Statement of Financial Position were reviewed for FY 1993. Those accounts were Fund Balances with Treasury ($1.4 billion), Inventories Held for Sale ($30.9 billion), Inventories Not Held for Sale ($3.35 billion), and Property, Plant and Equipment ($1.5 billion). The FY 1993 Statement of Financial Position reports total assets of $38.6 billion and total Revenues and Financing Sources of $12.3 billion. The Denver field office of the IG, DoD, assisted the AFAA by reviewing the DFAS Denver Center's work in preparing the financial statements. This report discusses the results of our audit work at the DFAS Denver Center. The AFAA issued four separate opinion reports on the results of its audits. For FY 1993, the AFAA expressed two adverse opinions and disclaimed two opinions on the four asset account balances.

Air Force management is responsible for establishing and maintaining an internal control structure. To fulfill this responsibility, management must make estimates and judgments to assess the expected benefits and related costs of the internal control policies and procedures. The objective of an internal control structure is to provide management with reasonable assurance that obligations and costs are in compliance with applicable laws; that funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and that DBOF revenues and expenditures are properly recorded and accounted for.

The Federal Accounting Standards Advisory Board (FASAB) is studying accounting principles that will apply to Government financial statements. Generally accepted accounting principles for Federal agencies are to be promulgated by the Comptroller General; the Office of Management and Budget (OMB); and the Secretary of the Treasury, based on recommendations from the FASAB. In the interim, Federal agencies are to follow the standards in their manuals for accounting policy and procedures, and related guidance. The summary of significant accounting policies included in the Notes

to the Principal Statements describes the standards prescribed by DoD Manual 7720.9-M, the "DoD Accounting Manual" that were used to prepare the FY 1993 financial statements.

The DoD has historically used revolving funds to provide services and supplies to its operating components. The revolving funds were established under 10 U.S.C. 2208 and implemented by DoD Directive 7420.13, "Stock Fund Operations," January 27, 1983, and the DoD Accounting Manual. Individual revolving funds were combined into the DBOF on October 1, 1991, to provide more efficient and effective service to customers. The DBOF is expected to recover its total costs from customers by selling goods and services. The following is a description of each of the DBOF business areas operated by the Air Force.

o The Supply Management business area manages and accounts for inventories of supplies; this business area generated 76 percent of the Air Force's total DBOF revenues for FY 1993. Supply Management operates as a revolving fund by acquiring inventories with funds from prior sales to customers.

o The Distribution Depot business area was established to collect and control the costs of inventory management and distribution depot management.

o The Base Support business area consists of the Laundry and Dry Cleaning Service, which uses Government-owned facilities to provide laundry, dry cleaning, and other textile services to the Government, DoD, and other authorized activities worldwide.

o The Transportation business area consists of the Air Mobility Command's (AMC's) transportation responsibilities that are unique to the Air Force. These responsibilities include the Executive travel mission, the use of operational support aircraft, the air weather service, AMC training, AMC base operations, tanker operations, and other functions. This business area was established during FY 1993 and will be disestablished beginning in FY 1995, in accordance with the DBOF Improvement Plan.

o The Depot Maintenance business area includes depot-level repair, maintenance, and overhaul of weapon system components and other major items.

Objective

Our original audit objective was to determine whether the Air Force Consolidated DBOF financial statements, prepared by the DFAS Denver Center for FY 1993, were presented fairly in accordance with accepted accounting principles. The objective was revised to correspond with the incremental audit approach that DoD audit organizations are using for the DBOF financial statements. Using the incremental audit approach, we audited four asset

accounts on the Air Force DBOF financial statement which were Fund Balances with Treasury; Inventories Held for Sale; Inventories Not Held for Sale; and Property, Plant and Equipment. Specifically, we performed the reviews and tests necessary to assess the accuracy of financial data, adequacy of internal controls, and compliance with laws and regulations. We also evaluated procedures that the DFAS Denver Center used to prepare the consolidated financial statements. The results of our audit were provided to AFAA for its use in expressing the overall opinion on the four Air Force DBOF financial statement accounts.

Scope and Methodology

We performed this financial-related audit during the period June 1993 through May 1994, in accordance with generally accepted Government auditing standards. Those standards were issued by the Comptroller General of the United States as implemented by the IG, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial information presented in the Principal Statements is free of material misstatements. Computer-processed data were used to support the four accounts audited; we determined that the data were unreliable because the reconciliations necessary for a non-transaction-driven general ledger were not performed. This deficiency was previously reported to DFAS managers, who are taking corrective actions. We did not use statistical sampling in our audit because of the unreliable data and because the records at the DFAS Denver Center were not sufficiently detailed.

In planning our audit tests, we considered the related internal control structure. We obtained an understanding of the internal control policies and procedures and assessed the level of risk in processing transactions for account balances. We also evaluated whether significant control policies and procedures had been properly designed and were operating effectively.

Scope Limitation. To support the Air Force Audit Agency in its audit of the Air Force portion of the Defense Business Operations Fund, we performed the audit work related to those functions performed by the DFAS Denver Center. Other organizations contacted are listed in Appendix C. We limited our review to four asset account balances: Fund Balances with Treasury; Inventories Held for Sale; Inventories Not Held for Sale; and Property, Plant and Equipment. The review of four accounts is in accordance with the incremental audit approach for FY 1993. The information used to prepare the financial statements was obtained from trial balance data transmitted to the DFAS Denver Center from Air Force locations worldwide. We did not evaluate the accuracy of the data provided by outside sources, which was the responsibility of the Air Force Audit Agency. We evaluated the DFAS Denver Center's procedures for ensuring data accuracy and completeness.

Internal Controls

The audit identified material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. To comply with OMB Bulletin No. 93-06, we evaluated the DFAS Denver Center's process for implementing the DoD Internal Management Control Program. The program was in place, but internal control weaknesses existed that had not been reported. The Internal Management Control Program failed to detect the weaknesses because DFAS used a questionnaire that focused on the automated portion of the accounting system and did not address the manual process.

Internal controls did not ensure the accurate presentation of Inventories Held for Sale on the Air Force DBOF financial statements. We reviewed internal controls over assets to determine whether assets were properly reported on the financial statements, and whether management complied with laws and regulations that have a direct and material effect on the financial statements. Weaknesses in internal controls resulted in high levels of risk and instances of noncompliance, and also resulted in misstatements that affected the DBOF business area and the consolidated financial statements. In some instances, internal controls were not present to detect errors or irregularities in a timely manner. DFAS Denver Center personnel also did not investigate negative balances reported by field activities. See Part II of this report for more information on the internal controls reviewed and specific internal control weaknesses.

Recommendations 1., 2., and 3., if implemented, will correct the internal control weaknesses related to negative balances reported in the FY 1993 Air Force DBOF financial statements. The monetary benefits to be realized by implementing the recommendations were not quantifiable because of the lack of internal controls and the lack of reliable data generated by the financial systems. However, improved inventory accounting and management could result in significant monetary benefits. Other benefits resulting from this audit are detailed in Appendix B, "Summary of Potential Benefits Resulting from Audit." A copy of the final report will be provided to the senior official responsible for internal controls within the Defense Finance and Accounting Service.

Prior Audits and Other Reviews

The General Accounting Office (GAO) issued financial audit reports in 1990 and 1992 on the Air Force financial statements, and the IG, DoD, performed six recent financial audits. The AFAA also performed 28 audits of the FY 1992 Air Force financial statements and 31 audits of the FY 1993 financial statements. The audits listed below apply specifically to this report. All audit report titles are listed in Appendix A.

General Accounting Office. GAO Report No. AFMD-90-23 (OSD Case No. 8193-A), "Air Force Does Not Effectively Account for Billions of Dollars of Resources," was issued in February 1990. The report's findings were that financial systems did not provide reliable financial data, basic internal control weaknesses existed, the full costs of weapon systems were not identified, and inventory systems did not provide accurate data. The Under Secretary of Defense (Comptroller) concurred with all 26 recommendations. The GAO recommended that the Air Force use existing financial information, develop more accurate financial information, perform reconciliations and document adjustments, account for the costs of weapon systems, achieve financial management of inventories, and develop a new accounting system. To date, the Air Force has made limited progress in correcting deficiencies in its financial management systems. DoD has emphasized long-term efforts to improve and standardize its financial management operations; the benefits of those efforts will not be realized for several years. The DFAS Denver Center devoted resources to making improvements in FY 1992, but made little progress in improving the financial systems. For example, the DFAS Denver Center trained over 400 Air Force personnel on the CFO Act and its requirements, and developed a pamphlet for self-paced training on the general ledger. During FY 1993, the DFAS Denver Center began, through Headquarters, DFAS, a significant effort to improve its financial management system. This effort is the Interim Migratory Accounting System, currently being developed. The DFAS Denver Center proposes to spend more than $100 million on this system to correct deficiencies mentioned in CFO audit reports and to improve other weaknesses.

GAO Report No. AFMD-92-12 (OSD Case No. 8376-L), "Aggressive Actions Needed for Air Force to Meet Objectives of the CFO Act," was issued in February 1992. The report's findings were that financial systems were not integrated and generated unreliable information; the reported costs of weapon systems were unreliable; accounting and controls over Air Logistics Command inventories were inadequate; internal accounting controls were inadequate; and short-term actions were needed to improve the quality of financial data and ensure completion of a financial statement audit. The GAO repeated all 26 recommendations in its February 1990 report and made additional recommendations to improve management's accountability, strengthen internal controls, improve the quality of financial information, and assist the Air Force in meeting the objectives of the CFO Act.

Inspector General, Department of Defense. Audit Report No. 94-159, "Fund Balances with Treasury Accounts on the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993," was issued on June 30, 1994. This audit determined that DoD's definition of fund balances did not meet the OMB guidelines. As a result, collection and disbursement data compiled by DFAS through the Appropriation Control and Reporting System lacked audit trails and proper period matching procedures; and data collected by DFAS were not reconciled to the Defense Logistics Agency's records. The DFAS Denver Center follows the same DoD policies as the Defense Logistics Agency. Therefore, Fund Balances with Treasury, as reported by the DFAS Denver Center, has the same problems. The report concluded that Fund Balances with Treasury is misleading and cannot be relied on.

Audit Report No. 94-073, "Defense Finance and Accounting Service Work on the Air Force FY 1992 Financial Statements," was issued on March 31, 1994. The audit identified material internal control weaknesses at the DFAS Denver Center. The DFAS Denver Center lacked internal controls over the general ledger and the supplemental journal voucher system, accounts receivable, and military pay; the budget execution process; adjustments to the Statement of Operations; and Construction in Progress. Final comments, which were received from the DFAS Denver Center on June 6, 1994, required mediation by the Assistant Inspector General for Analysis and Followup, DoD; all issues have been mediated.

Air Force Audit Agency. For FY 1993, the AFAA was performing work on 13 audit reports for the Air Force General Fund consolidated financial statements and 18 audit reports for DBOF. For the FY 1992 financial statements, the AFAA completed 1 audit on the Air Force consolidated financial statements, 16 audits on general funds, 1 audit on trust funds, and 10 DBOF audits. The FY 1992 and 1993 audits were performed concurrently with our audits.

For FY 1992, the AFAA disclaimed opinions on the Air Force General Fund and DBOF financial statements. On June 30, 1994, the AFAA expressed adverse opinions on the DBOF financial statements on Property, Plant and Equipment (Project No. 94068019) and Inventories Not Held for Sale (Project No. 94068018), and disclaimed opinions on Fund Balances with Treasury (Project No. 94068020) and Inventories Held for Sale (Project No. 94068017). For FY 1993, the AFAA disclaimed an opinion on the Air Force General Fund financial statements in Project No. 94053022, "Opinion on Fiscal Year 1993 Air Force Consolidated Financial Statements," June 30, 1994.

Part II - Finding and Recommendations

Negative Account Balances

The DFAS Denver Center used negative account data to compute the ending inventory balances on the financial statements and the Annual Statement of Assurance, and footnotes did not address negative Inventory in Transit amounts. Those conditions occurred because of inadequate internal controls at the DFAS Denver Center; inadequate research into the causes of negative inventory balances; the inability to resolve negative Inventory in Transit data; and inadequate disclosures by the DFAS Denver Center. As a result, we could not verify the accuracy of negative inventory account balances totaling $300.5 million, or negative Inventory in Transit data totaling $1.1 billion, which were used in the financial statements of the Supply Management business area and the consolidated financial statements of the Defense Business Operations Fund. Also, users of the financial statements were not informed, through footnotes, of the negative Inventory in Transit amounts.

Background

The DFAS Denver Center used summary accounting data from worldwide Air Force locations to prepare the Air Force's DBOF FY 1993 financial statements. The summary accounting data were generated by various accounting and nonaccounting systems. The documentation supporting the individual transactions was maintained by Air Force activities and was not readily available to the DFAS Denver Center.

The DoD Accounting Manual lists the characteristics of assets. The following characteristics must be present for an item to qualify as an asset:

o The asset must provide probable future economic benefits that enable it to provide future net cash inflows.

o The entity must be able to receive the benefit and restrict other entities' access to that benefit.

o The event that provides the entity with the right to the benefit must have occurred.

Asset accounts normally have debit balances, representing the future net cash inflows they will provide. The certified summary accounting data received by the DFAS Denver Center included substantial negative (credit) balances for tangible asset accounts.

The DFAS Denver Center computed the balance of Inventory in Transit as the difference between Transfers In and Transfers Out of inventory, as reported by the field activities. On September 30, 1993, the balance of Inventory in Transit was negative, indicating that the field activities had submitted incorrect data.

Quality of Accounting Information

Internal Controls. The accounting system did not contain adequate internal controls to prevent the processing of incorrect data, as required by the DoD Accounting Manual, chapter 14, "Internal Controls." The DFAS Denver Center's system allowed negative account data to be processed and included in the financial statements without adequate review by DFAS Denver Center personnel to determine the validity of the data.

Negative Inventory Account Balances. The DFAS Denver Center did not adequately research negative inventory account balances provided by field activities before including these balances in the financial statements. The information transmitted to the DFAS Denver Center included 23 negative inventory account balances totaling $465.6 million. Although the DFAS Denver Center requested the major commands (MAJCOMs) validate these negative balances, the DFAS Denver Center received validation for only 10 balances. The remaining 13 balances represented 65 percent ($300.5 million) of the total negative inventory balances received. The DFAS Denver Center did not perform further research or footnote the financial statements to indicate that these negative balances distorted the financial position.

Negative Balance in Inventory in Transit. Personnel at the DFAS Denver Center did not have sufficient information to research and correct data that resulted in a net negative Inventory in Transit balance on the financial statements. The Inventory in Transit balance is included in the Inventories Held for Sale line item on the financial statements. A total net negative in-transit balance is incorrect, since it represents a net negative asset. The DFAS Denver Center agreed that deficiencies existed in the inventory in-transit accounting system and requested audit assistance from the AFAA to identify and resolve those problems. During FY 1995, the AFAA will assist the DFAS Denver Center by offering a management advisory service (Project No. 95068017). This project will focus on the supply systems used by the field activities to account for inventory.

The balance of Inventory in Transit is computed as the difference between field activities' Transfers In and Transfers Out. When the total reported Transfers In exceeds the total reported Transfers Out, a negative Inventory in Transit balance results. Individual field activities may legitimately have more transfers in than transfers out; if this is the case, no questionable condition exists. However, when used to compute the department-level Inventory in Transit amount, the negative balance is illogical.

The DFAS Denver Center had no department-level system to match individual Transfers In and Transfers Out. Although the total inventory transfer accounts were not negative, they contributed to a net negative balance of over $1.1 billion as of September 30, 1993. As of May 31, 1994, the negative Inventory in Transit amount had increased to $9.6 billion. Departmental analysis of the individual transactions would be difficult due to the large volume of data required.

In accordance with OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements," October 22, 1992, financial statements must include footnotes that fully inform the reader. The Air Force DBOF financial statements did not include a footnote explaining the unreliability of the data used to compute the negative $1.1 billion in the financial statements. In addition, DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, requires each DoD Component to submit an Annual Statement of Assurance to the Secretary of Defense, indicating whether the Internal Management Control Program meets its standards, goals, and objectives. The Annual Statement of Assurance for FY 1993 did not disclose the problem with negative in-transit inventories.

Corrective Actions Taken

The DFAS Denver Center has improved its research on questionable negative balances in the Supply Management business area. A monthly report identifies these balances. Field activities that report negative account balances are identified and asked to validate or correct questionable balances. Followup is performed when field activities do not respond to the initial request for validation and correction. The follow-up procedures were not in effect for the September 30, 1993, financial statements. In future audits, we will evaluate the effects of those procedures on the financial statements.

Recommendations, Management Comments, and Audit Response

Added and Deleted Recommendations. Comments from the Director, DFAS, stated that the data required to perform a detailed review of the inventory transfer transactions are not available to the DFAS Denver Center. The Director also stated that the logistics community already reconciles inventory transfer transactions, and a similar reconciliation by the DFAS Denver Center would be duplicative. Based on those management comments, we have deleted draft report Recommendations 4., 5., and 6. We added new Recommendations 4. and 5. (see below) to the final report to address actions that can be taken by the DFAS Denver Center. We request that management, in its comments on the final report, respond to the new recommendations.

We recommend that the Director, Defense Finance and Accounting Service Denver Center, establish and implement internal controls to:

1. Identify negative balances.

Management Comments. Management concurred with this recommendation, stating that the DFAS Denver Center and base-level personnel currently identify negative balances.

Audit Response. Management's comments were responsive to the recommendation. No further action is required.

2. Prioritize the most significant and questionable balances.

Management Comments. Management nonconcurred with this recommendation, stating that the DFAS Denver Center believes that all negative balances are questionable and requests that MAJCOMs validate them.

Audit Response. Management's comments were responsive. We agree that all negative balances should be corrected. In the past, the DFAS Denver Center did not validate all questionable balances; however, at a minimum, the material amounts should be corrected. Management requested validation for all abnormal balances reported on September 30, 1993, but did not receive responses from all field activities. After we issued our draft report, the DFAS Denver Center found validation from field activities for 10 of 23 negative inventory balances, representing 35 percent ($165.1 million/$465.6 million) of the total negative inventory dollars. One of the 13 negative balances not validated by the DFAS Denver Center represented 41 percent ($190.8 million/$465.6 million) of the total negative inventory dollars. Therefore, we revised our report. Procedures are now in place to correct this problem.

3. Contact field activities to ensure that negative asset balances are researched and corrected before inclusion in the Statement of Financial Position.

Management Comments. Management concurred with this recommendation, stating that field activities are contacted several times to validate negative asset balances and, if necessary, take corrective action.

Audit Response. Management's comments were responsive to the recommendation. The DFAS Denver Center did contact field activities to validate the 23 negative inventory balances reported for September 30, 1993. However, although the 10 responses indicated that the negative inventory balances were correct, the DFAS Denver Center did not challenge the negative balances. The concept of negative inventory is illogical, and the DFAS Denver Center needed to obtain sufficient documentation from the field activities to correct the negative amounts and follow up when field activities do not respond to requests for validation. Procedures are now in place to correct this problem.

4. Add a footnote to the Air Force Defense Business Operations Fund financial statements, explaining that the data used to compute the ending inventory balances came from systems that may not be reliable.

5. Disclose the lack of sufficient internal controls over Inventory in Transit accounting as a material weakness in the Defense Finance and Accounting Service's Annual Statement of Assurance.

See Part IV for the complete text of management's comments on the draft report. Comments on the final report must be received by March 13, 1995. The chart below gives details specific requirements for those comments.

Response Requirements for Each Recommendation

Responses to the final report are required from the Defense Finance and Accounting Service Denver Center for the items indicated with an "X" in the chart below.

	Response Should Cover:			
Number	Concur/ Nonconcur	Proposed Action	Completion Date	Related Issues*
4.	X	X	X	CO
5.	X	X	X	CO

*CO = compliance with laws and regulations.

Part III - Additional Information

Appendix A. Prior Audit Reports

General Accounting Office

Report No. AFMD-90-23 (OSD Case No. 8193-A), "Air Force Does Not Effectively Account for Billions of Dollars of Resources," February 23, 1990

Report No. AFMD-92-12 (OSD Case No. 8376-L), "Aggressive Actions Needed for Air Force to Meet Objectives of the CFO Act," February 19, 1992

IG, DoD, Audit Reports

Report No. 92-119, "Defense Agency Trust Fund Financial Statements for FY 1991," June 30, 1992

Report No. 93-134, "Principal and Combining Financial Statements of the Defense Business Operations Fund - FY 1992," June 30, 1993

Report No. 94-035, "Financial Reporting Procedures for Defense Distribution Depots - Defense Logistics Agency Business Area of the Defense Business Operations Fund," February 8, 1994

Report No. 94-062, "Financial Status of Air Force Expired Year Appropriations," March 18, 1994

Report No. 94-073, "Defense Finance and Accounting Service Work on the Air Force FY 1992 Financial Statements," March 31, 1994

Report No. 94-159, "Fund Balances with the Treasury Accounts on the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for Fiscal Year 1993," June 30, 1994

Air Force Audit Agency Reports

Project No. 94068017, "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Inventories Held for Sale Balance," June 30, 1994

Project No. 94068018, "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Inventories Not Held for Sale Balances," June 30, 1994

Project No. 94068019, "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Property, Plant, and Equipment Balances," June 30, 1994

Project No. 94068020, "Opinion on Air Force Defense Business Operations Fund, Fiscal Year 1993 Fund Balance With Treasury," June 30, 1994

Project No. 94053022, "Opinion on Fiscal Year 1993 Air Force Consolidated Financial Statements," June 30, 1994

Project No. 93053007, "Review of the Equipment and Vehicle Inventory, Fiscal Year 1993 Air Force Consolidated Financial Statements," July 22, 1994

Project No. 93053013, "Review of Military Personnel Costs, Fiscal Year 1993 Air Force Consolidated Financial Statements," July 1, 1994

Project No. 93053014, "Review of Civilian Payroll, Fiscal Year 1993 Air Force Consolidated Financial Statements," June 6, 1994

Report No. 93053015, "Review of the Accuracy and Validity of Air Force Obligations, Fiscal Year 1993 Air Force Consolidated Financial Statements," August 26, 1994

Project No. 93053020, "Review of Cash Operations and Reporting of Payments and Collections, Fiscal Year 1992 Air Force Consolidated Financial Statements," February 4, 1994

Report No. 93053024, "Review of Military Equipment, Fiscal Year 1993 Air Force Consolidated Financial Statements," July 20, 1994

Project No. 94053021, "Review of Management Initiatives to Improve Financial Reporting, Fiscal Year 1993 Air Force Consolidated Financial Statements," August 8, 1994

Project No. 94053024, "Review of Contingent Liabilities, Fiscal Year 1993 Air Force Consolidated Financial Statements," August 8, 1994

Project No. 94053026, "Review of the Real Property Accounting Process, Fiscal Year 1993 Air Force Consolidated Financial Statements," July 27, 1994

Project No. 94053029, "Review of Overview and Performance Measures, Fiscal Year 1993 Air Force Consolidated Financial Statements," August 8, 1994

Project No. 94053030, "Review of the Fund Control Process, Fiscal Year 1993 Air Force Consolidated Financial Statements," August 26, 1994

Project No. 94053031, "Review of Inventories Not Held For Sale, Fiscal Year 1993 Air Force Consolidated Financial Statements," July 1, 1994

Project No. 93068002, "Financial Reporting of Fiscal Year 1993 Medical/Dental Division Inventories Within the Supply Management Business Area," July 11, 1994

Project No. 93068004, "Internal Control and Management Issues Related to Air Force Depot Maintenance Service Fiscal Year 1992 Financial Statements," December 17, 1993

Project No. 93068006, "Financial Reporting of Fiscal Year 1993 Inventories Not Held for Sale Within the Depot Maintenance Service Business Area," April 18, 1994

Appendix A. Prior Audit Reports

Project No. 93068007, "Internal Control and Management Issues Related to Disbursements for Supplies and Services, Fiscal Year 1993 Financial Statements," April 15, 1994

Project No. 93068008, "Financial Reporting of Fiscal Year 1993 Revenue, Accounts Receivable, and Progress Billing Within the Depot Maintenance Service Business Area," July 1, 1994

Project No. 93068009, "Financial Reporting of Fiscal Year 1993 Accrued Liabilities Within the Depot Maintenance Service Business Area," June 21, 1994

Project No. 93068010, "Financial Reporting of Fiscal Year 1993 Property, Plant, and Equipment Within the Depot Maintenance Service and Supply Management Business Areas," July 1, 1994

Report No. 93068016, "Financial Reporting of Fiscal Year 1993 Inventories Within the Supply Management Business Area," August 26, 1994

Report No. 93068028, Quick-Reaction Report, "Air Force Depot Maintenance Service, Fiscal Year 1993 Financial Statements," February 14, 1994

Report No. 93068031, "Financial Reporting of Fiscal Year 1993 Revenues and Expenses Within the Supply Management Business Area," July 1, 1994

Report No. 94068021, "Financial Reporting of Fiscal Year 1993 Property, Plant and Equipment Within the Transportation Service Business Area," July 11, 1994

Report No. 94068022, "Financial Reporting of Fiscal Year 1993 Inventories Within the Transportation Services Business Area," June 21, 1994

Report No. 94068025, Quick-Reaction Report, "Air Force Depot Maintenance Service, Fiscal Year 1993 Material In-Transit Balances," April 1, 1994

Report No. 94068026, "Financial Reporting of Fiscal Year 1993 Disbursements and Collections Within the Air Force Defense Business Operations Fund," August 8, 1994

Project No. 92053011, "Opinion on FY 1992 Air Force Consolidated Financial Statements," June 29, 1993

Project No. 92053003, "Review of Military Payroll Process," October 12, 1993

Project No. 92053004, "Review of the Civilian Payroll Process," January 12, 1994

Project No. 92053007, "Review of Cash Operations," October 27, 1992

Project No. 92053008, "Review of the Military Equipment Inventory Process - Aircraft," November 15, 1993

Project No. 92053009, "Review of the Military Equipment Inventory Process - Satellites," October 21, 1993

Project No. 92053010, "Review of the Liabilities Process," January 14, 1994

Project No. 92053012, "Review of the Military Equipment Inventory Process - Guided and Ballistic Missiles," October 21, 1993

Project No. 92053013, "Review of the Budget Allocation and Fund Control Process," December 3, 1993

Project No. 92053014, "Review of the Operating Consumable Inventory Process," November 12, 1992

Project No. 92053015, "Review of the Accounts Receivable Process," December 17, 1993

Project No. 92053016, "Review of the Real Property Inventory Process," January 25, 1994

Project No. 92053017, "Review of the General Fund Revenue Process," October 30, 1992

Project No. 92053018, "Review of the Equipment and Vehicle Inventory Process," January 24, 1994

Project No. 92053019, "Review of the General Fund Operating Expenditure Process," January 10, 1994

Project No. 92053020, "Air Force Implementation of Section 4 (Accounting Systems) of the Federal Managers' Financial Integrity Act," November 3, 1993

Project No. 92053023, "Review of the Military Equipment Inventory Process - Uninstalled Engines, Fiscal Year 1992 Air Force Consolidated Financial Statements," October 21, 1993

Project No. 92053022, "Review of the Trust Funds Supplemental Financial Information, Fiscal Year 1992 Air Force Consolidated Financial Statement," June 30, 1993

Report No. 92068004, "Internal Control and Management Issues Related to Air Force Supply Management, Cost of Operations Division, FY 1992 Financial Statements," December 3, 1993

Report No. 92068010, "Internal Control and Management Issues Related to Air Force Supply Management, General Support Division FY 1992 Financial Statements," January 12, 1994

Project No. 92068012, "Internal Control and Management Issues Related to Air Force Supply Management, Repairable Support Division FY 1992 Financial Statements," January 28, 1994

Appendix A. Prior Audit Reports

Project No. 92068013, "Internal Control and Management Issues Related to Air Force Supply Management, Fuels Division FY 1992 Financial Statements," December 16, 1993

Project No. 92068040, "Internal Control and Management Issues Related to Air Force Supply Management, Systems Support Division FY 1992 Financial Statements," November 16, 1993

Project No. 92068002, "Opinion on Air Force Depot Maintenance Service, Defense Business Operations Fund, FY 1992 Financial Statements," June 30, 1993

Project No. 92068003, "Opinion on Laundry and Dry Cleaning Service, Defense Business Operations Fund, FY 1992 Financial Statements," June 30, 1993

Project No. 92071002, "Opinion on Air Force Transportation, Defense Business Operation Fund FY 1992 Financial Statements," June 29, 1993

Project No. 92066002, "Review of General and Application Controls Within the Equipment Inventory, Multiple Status and Utilization Reporting System," April 1, 1993

Project No. 92066010, "Review of General and Application Controls Within the Contract Depot Maintenance Production and Cost System," April 1, 1993

Appendix B. Summary of Potential Benefits Resulting from Audit

Recommendation Reference	Description of Benefit	Type of Benefit
1., 2., and 3.	Internal controls. Implementing internal controls over data from field activities will improve the reliability of the Air Force DBOF financial statements.	Nonmonetary.
4. and 5.	Compliance. Disclosure of problems with in-transit accounting will give users relevant information.	Nonmonetary.

Appendix C. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller), Office of the Deputy Comptroller (Management Systems), Director, Financial Management Policy, Washington, DC

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller), Director of Budget Management and Execution, Washington, DC
Air Force Audit Agency, Acquisition and Logistics Support Directorate, Wright-Patterson Air Force Base, OH

Defense Agencies

Defense Finance and Accounting Service, Arlington, VA
Defense Finance and Accounting Service Center, Denver, CO

Non-Defense Organizations

Federal Accounting Standards Advisory Board, Washington, DC
General Accounting Office, Washington, DC

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Assistant to the Secretary of Defense (Public Affairs)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Auditor General, Department of the Navy

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and Comptroller)
  Director (Audit Liaison and Follow-up)
Auditor General, Air Force Audit Agency
  Financial and Support Audits Directorate
  Acquisition and Logistics Audit Directorate

Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
  Director, Customer Service and Performance Assessment Deputate
    Director, Defense Finance and Accounting Service Columbus Center
    Director, Defense Finance and Accounting Service Denver Center
      Internal Review Office
Director, Defense Logistics Agency
Director, National Security Agency

Inspector General, Central Imagery Office
Inspector General, Defense Intelligence Agency
Inspector General, National Security Agency
Director, Defense Logistics Studies Information Exchange

Non-Defense Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division, General Accounting Office

Chairman and Ranking Minority Member of Each of the Following Congressional Committees and Subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part IV - Management Comments

Defense Finance and Accounting Service Comments

DEFENSE FINANCE AND ACCOUNTING SERVICE

1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291

DFAS-HQ/AD

SEP 19 1994

MEMORANDUM FOR DIRECTOR, FINANCIAL MANAGEMENT DIRECTORATE,
INSPECTOR GENERAL, DOD

SUBJECT: DoD(IG) Draft Report, "Defense Finance and Accounting Service Work on the FY 1993 Air Force Defense Business Operations Fund Financial Statements" (Project No. 3FD-2041)

As requested in your memorandum dated July 20, 1994, subject as above, we have reviewed the recommendations in the subject audit pertaining to the Defense Finance and Accounting Service. Our comments are attached.

My point of contact is Mr. Bill deBardelaben. He may be contacted at (703) 607-1581/79.

Daniel Turner
Deputy Director for Business Funds

Attachment

Final Report Reference

DoD(IG) Draft Report, "Defense Finance and Accounting Service Work on the FY 1993 Air Force Defense Business Operations Fund Financial Statements" (Project No. 3FD-2041)

Recommendations: That the Director, Defense Finance and Accounting Service, establish and implement internal controls to:

1. Identify negative balances;

2. Prioritize the most significant and questionable balances:

3. Contact field activities to ensure that negative asset balances are researched and corrected before inclusion in the Statement of Financial Position;

4. Review in-transit amounts that exceed reasonableness levels for each field activity; Deleted.

5. Match transfers in with the corresponding transfers out to ensure the accuracy of all data; and Deleted.

6. Validate questionable data and resolve the differences before including Inventory in Transit in the Statement of Financial Position. Deleted.

DFAS Comments:

1. Concur. DFAS and base-level personnel already identify negative balances. DFAS believes existing internal controls are adequate to detect and validate negative balances. We have procedures to accomplish this monthly and at year-end. We do not attempt to prevent negative balances because many are valid. DFAS used data that was validated by the field activities and certified by the base comptroller.

2. Nonconcur. DFAS believes all negative balances are questionable and requests MAJCOMs validate them.

3. Concur. DFAS already contacts field activities to initiate validation and, if necessary, corrective action. There are valid reasons for some abnormal balances and corrective action is not always required. DFAS believes its actions were adequate in the validation efforts of the negative account data. During end-of-year FY 93 processing, bases included 23 negative inventory accounts in the 750 trial balance transmissions. Validation requirements included: (a) AFM 177-383 requirement to research all abnormal balances, initiate corrective action, and annotate action on hard copy trial balance; (b) DFAS issued a message requiring all bases to provide results of their research; (c) Monthly Stock Fund Analysis was provided to all MAJCOMs asking them to validate all questionable data and provide results of their research and actions taken.

Final Report Reference

Deleted.

4. Nonconcur. Reasonable levels for in-transit amounts are impossible to predict. Item management responsibility transfers, re-leveling, base closures, etc., make this account fairly unpredictable. Also, the term "review" is given too much credibility. Departmentally, there are no tools to perform a review. Any review would result in notifying suspect bases, who in turn would request the logistics associates for their input. Returning comments would invariably be that the transactions are correct.

Deleted.

5. Nonconcur. This type of transaction level reconciliation at the departmental-level would have an exorbitant cost and duplicate the efforts of the logistics community. Currently, the Stock Control and Distribution System (SC&D) at Wright-Patterson AFB, Ohio, collects data from all logistics systems to monitor transfers-out with transfers-in. The reparable support division assets are monitored on a line-item basis, whereas the system support division data is provided on a net change basis. If the line-item reconciliation, accomplished by the logisticians, provides the necessary internal controls between their supply accounts then, the accounting updates, provided by those supply source transactions, would be deemed accurate.

Deleted.

6. Nonconcur. The validation of questionable balances must occur at a level above the supply accounts, but below departmental processing. This is because at any particular base, actions which result in a transfer-in or a transfer-out are mutually exclusive. Also, as stated in the management comments to recommendation 5, to duplicate the logistics line-item reconciliation at the departmental-level would have an exorbitant cost. There are, however, strengthening of internal controls at the source systems which may help resolve this issue. One current effort will begin with the Air Force Audit Agency's (AFAA) Audit Project No. 94068036, "Air Force Wholesale and Retail Supply Management, Defense Business Operations Fund, Fiscal Year 1994 Inventories." The AFAA has agreed to work with DFAS in identifying and resolving problems apparent in the inventory in-transit accounting arena. They have personnel who can focus their full-time effort in researching the process. By working with them, DFAS can be assured that the AFAA findings would be detailed enough for them to request the proper changes to computer systems.

Audit Team Members

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