Audit Report

OFFICE OF THE INSPECTOR GENERAL

STATEMENT OF FINANCIAL POSITION FOR THE DEFENSE LOGISTICS AGENCY DISTRIBUTION DEPOT BUSINESS AREA OF THE DEFENSE BUSINESS OPERATIONS FUND, AS OF SEPTEMBER 30, 1994

Report No. 95-197

May 19, 1995

Department of Defense

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Acronyms

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
IG	Inspector General
OMB	Office of Management and Budget

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
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May 19, 1995

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER OF THE
DEPARTMENT OF DEFENSE
DIRECTOR, DEFENSE LOGISTICS AGENCY
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on the Statement of Financial Position for the Defense Logistics Agency Distribution Depot Business Area of the Defense Business Operations Fund as of September 30, 1994 (Report No. 95-197)

We are providing this report for your information and use and for use by the Congress. Financial statement audits are required by the Chief Financial Officers Act of 1990. Office of Management and Budget Bulletin No. 93-06 "Audit Requirements for Federal Financial Statements," January 8, 1993, requires the Inspector Gereral, Department of Defense, to report on the adequacy of internal controls and compliance with laws and requlations and express an opinion on the fairness of financial statements. Comments from the Office of the Secretary of Defense (Comptroller) were considered in the preparation of this report.

We are unable to render an opinion on the Statement of Financial Position because internal controls over the accounting processes and systems, although being improved, did not ensure accurate and reliable data for the preparation of the financial statement. Those internal control weaknesses were recognized and reported in the Department of Defense, the Defense Logistics Agency, and the Defense Finance and Accounting Service Annual Statements of Assurance and in the notes to the financial statements. Our disclaimer of opinion is based on the Statement of Financial Position as of September 30, 1994, but dated January 11, 1995.

Management is not required to provide comments because this report contains no recommendations and identifies no potential monetary benefits that are subject to resolution in accordance with DoD Directive 7650.3. Any comments you wish to make should be received by July 5, 1995.

The courtesies extended to the audit staff are appreciated. If you have any questions about this audit, please contact Mr. Charles Hoeger, Audit Program Director, at (215) 737-3881 (DSN 444-3881) or Mr. John Issel, Audit Project Manager, at (614) 337-8009. The distribution of this report is in Appendix D. A list of audit team members is on the inside back cover.

Robert J. Lieberman

Robert J. Lieberman
Assistant Inspector General
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Office of the Inspector General, DoD

Report No. 95-197 **May 19, 1995**
(Project No. 4LD-2007)

Statement of Financial Position for the Defense Logistics Agency Distribution Depot Business Area of the Defense Business Operations Fund, as of September 30, 1994

Executive Summary

Introduction. The Chief Financial Officers Act of 1990 requires the annual preparation and audit of financial statements for revolving funds. The Defense Logistics Agency (DLA) distribution depots are part of the DoD Defense Business Operations Fund. The major mission of the distribution depots is to receive, store, maintain, pack, and issue supplies to support U.S. Armed Forces worldwide.

This audit is one of a series being conducted by the Inspector General, DoD, in response to the Chief Financial Officers Act. The audit was performed in conjunction with audits of the DLA Supply Management Business Area (Project No. 4LD-2006) and the Reutilization and Marketing Business Area (Project No. 4LE-2008). The audits are part of a building block approach to provide audit coverage of the DLA business areas of the Defense Business Operations Fund.

Objectives. The objectives of the audit were to determine whether the Statement of Financial Position for the DLA Distribution Depot Business Area was presented fairly, in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. We evaluated the adequacy of the Defense Finance and Accounting Service and DLA internal control structure for financial data, and assessed compliance with laws and regulations that could have a material effect on the financial data. Additionally, we followed up on conditions noted in Inspector General, DoD, Report No. 94-149, "Property, Plant, and Equipment Accounts on the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993," June 28, 1994, and Inspector General, DoD, Report No. 94-167, "Selected Financial Accounts on the Defense Logistics Agency Defense Business Operations Fund Financial Statements for FY 1993," June 30, 1994.

Scope and Methodology. We examined the Statement of Financial Position as of September 30, 1994, and Notes related to the statement for the Distribution Depot Business Area of the DLA Defense Business Operations Fund. The Statement of Financial Position upon which our disclaimer of opinion is based was dated January 11, 1995.

We examined the internal control structure for the $1,157.2 million reported for the accounts receivable and property, plant, and equipment accounts, and the $469.5 million accounts payable because the accounts represented 98 percent of the distribution depots' assets and 73 percent of the depots' liabilities as reported on the Statement of Financial Position. The audit entailed the use of computer-processed financial data and reports. We determined the reliability of the computer-processed data as related to the accounts reviewed.

Disclaimer of Opinion. We are unable to render an opinion on the FY 1994 Statement of Financial Position for the DLA Distribution Depot Business Area because internal controls over the accounting processes and systems did not provide accurate and reliable data for the preparation of the financial statement. DoD, the Defense Finance and Accounting Service, and DLA recognized and reported the material internal control weaknesses in their Annual Statements of Assurance. Financial statement inaccuracies were also addressed in notes to the statement.

Internal Controls. Part II.A. contains our report on internal controls. DoD, the Defense Finance and Accounting Service, and DLA recognized that material internal control weaknesses existed, in that accounting processes and systems were not adequate to provide reasonable assurance that material misstatements in the financial records and statements would be prevented or detected in a timely manner.

Compliance With Laws and Regulations. Part II.B. contains our report on compliance with laws and regulations. Other than the issues discussed in Part II.A., our examination disclosed no material instances of noncompliance with laws and regulations. The laws and regulations that we tested are listed in Appendix B.

Management Comments and Audit Response. Although the report contained no recommendations, we received comments from the Office of the Under Secretary of Defense (Comptroller). The Deputy Chief Financial Officer stated that he agreed in principle with the findings in the report, except our reference to a previous report on fund balance with the Treasury accounts. Also, he stated that the Office of the Under Secretary of Defense (Comptroller) issued guidance on January 5, 1995, to make fund balance reporting more in line with Office of Management and Budget guidelines, and procedures to effect adjustments to general ledger accounts resulting from undistributed amounts were included in volume IIB of the DoD Financial Management Regulation. The complete text of the Deputy Chief Financial Officer's comments is in Appendix E.

In response to the comments received, we expanded our summation of the previously issued audit report (Appendix A, Report No. 94-159). The Defense Finance and Accounting Service and DLA advised us that they will not be providing comments. Comments on this final report are not required. However, should the Under Secretary of Defense (Comptroller); the Director, DLA; and the Director, Defense Finance and Accounting Service, choose to comment, the comments should be provided by July 5, 1995.

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Part I - Disclaimer of Opinion

Disclaimer of Opinion

We are unable to render an opinion on the Statement of Financial Position for the Defense Logistics Agency Distribution Depot Business Area (DLA Distribution Depots) of the Defense Business Operations Fund (DBOF) because internal controls over the accounting processes and systems did not provide accurate and reliable data for the preparation of the financial statement. DoD, the Defense Finance and Accounting Service (DFAS), and the DLA recognized and reported the material internal control weaknesses in their Annual Statements of Assurance. Financial statement inaccuracies were also addressed in notes to the statements (see Part II.A. for details). Our disclaimer of opinion is based on the Statement of Financial Position as of September 30, 1994, but dated January 11, 1995.

Auditing Standards

We conducted our audit in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General (IG), DoD, and Office of Management and Budget (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 about whether the Principal Statements are free of material misstatements. We relied on the guidelines suggested by the General Accounting Office and on our professional judgment in assessing the materiality of matters impacting the fair presentation of the financial statements and related internal control weaknesses.

Accounting Principles

Accounting principles and standards for the Federal Government remain under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Director, OMB; the Secretary of the Treasury; and the Comptroller General, who are principals of the Joint Financial Management Improvement Program. Specific standards agreed on by the principals are issued by the Director, OMB, and the Comptroller General.

Until accounting standards that will govern all aspects of financial statement reporting have been issued, which will constitute "generally accepted accounting principles for the Federal Government," agencies are required to follow the hierarchy of accounting principles described in OMB Bulletin No. 94-01, "Form

and Content of Agency Financial Statements," November 16, 1993. The hierarchy constitutes an "other comprehensive basis of accounting" to be used for preparing Federal agency financial statements. The hierarchy defined and approved by the Joint Financial Management Improvement Program principals is summarized as:

o standards agreed to and published by the Joint Financial Management Improvement Program principals,

o form and content requirements of OMB,

o accounting standards contained in agency accounting policy guidance, and

o accounting principles published by other authoritative sources.

To date, three accounting standards have been published by the Joint Financial Management Improvement Program principals, so most accounting standards for the DoD "other comprehensive basis of accounting" are contained in DoD accounting policy guidance. The DoD accounting guidance is primarily in the DoD Manual 7220.9-M, "DoD Accounting Manual," October 1983. During FY 1993 and FY 1994, the then Comptroller of the DoD, now the Under Secretary of Defense (Comptroller), updated portions of the DoD Accounting Manual and incorporated the published updated information into a new regulation, DoD 7000.14-R, "DoD Financial Management Regulation," May 1993.

The DoD Financial Management Regulation will eventually serve as the single DoD-wide financial management regulation for use by all DoD Components for accounting, budgeting, finance, and financial management education and training. In the interim, unless superseded by published Federal accounting standards or requirements of OMB, the policy contained in the DoD Accounting Manual or in the DoD Financial Management Regulation, as applicable, is the authoritative basis for preparing financial statements in accordance with an "other comprehensive basis of accounting."

Overview

We reviewed the financial data presented in management's Overview of the DLA Distribution Depots. The financial data in the Overview is presented for the purpose of additional analysis. We have not examined the supporting documentation for the financial data presented; therefore, we are not expressing an opinion on it.

Concurrent Audits

This audit was performed in conjunction with audits of the DLA Supply Management Business Area (Project No. 4LD-2006) and Reutilization and Marketing Service Business Area (Project No. 4LE-2008). The audits are part of a building block approach to provide audit coverage of the DLA business areas of the DBOF.

Part II - Audit Results

Audit Background

Formation of the Distribution Depot Business Area under DLA was completed in April 1992 with the consolidation of 23 Service depots with 7 DLA depots. The major mission of the distribution depots is to receive, store, maintain, pack, and issue supplies to support U.S. Armed Forces worldwide. The distribution depots earn funds to cover their expenses by charging customers, primarily the military components' inventory control activities, for services provided. Distribution depot earnings were based on the DBOF supply management areas' (that is, the supply management activities of the Services and DLA) counts of materiel issues and receipts by the distribution depots. The charge for services provided by the distribution depots is added to the cost of material sold to customers by the DBOF supply management activities.

In January 1991, DFAS was established by combining the Services' and the DLA financial centers to improve finance and accounting services and to reduce costs by adopting standard policies, procedures, and systems. DFAS-Columbus Center provides financial services for the distributions depots; and has to rely on distribution depots' input to the DFAS accounting system. Distribution depot personnel forward documentation to DFAS-Columbus Center and make data entries into the DFAS Defense Business Management System. DFAS-Columbus Center maintains the data system, makes payments and collections, processes documentation, and prepares financial statements for the DLA business areas of the DBOF.

The Chief Financial Officers' Act requires an annual audit of funds such as the DBOF. The DFAS and DLA are jointly responsible for preparing the DLA Distribution Depots' financial statements. Our responsibility is to express an opinion on those statements based on our examination.

Audit Objectives

The objectives of the audit were to determine whether the Statement of Financial Postion, as of September 30, 1994, for the DLA Distribution Depots was presented fairly in accordance with OMB Bulletin No. 94-01. We evaluated the adequacy of the DFAS and DLA internal control structure for financial data, and assessed compliance with laws and regulations that could have a material effect on the financial data. Additionally, we followed up on conditions noted in IG, DoD, Report No. 94-149, "Property, Plant, and Equipment Accounts on the Defense Logistics Agency Business Areas of the Defense Business and Operations Fund for FY 1993," June 28, 1994, and IG, DoD, Report No. 94-167, "Selected Financial Accounts on the Defense Logistics Agency Defense Business Operations Fund Financial Statements for FY 1993," June 30, 1994.

Scope and Methodology

We examined the Statement of Financial Position as of September 30, 1994, and associated notes to the Principal Statements for the DLA Distribution Depot Business Area of the DBOF. The Principal Statements include the Statement of Financial Position, Statement of Operations, Statement of Cash Flows, and Statement of Budget and Actual Expenses. The statements provided financial information as of September 30, 1994, but were dated January 11, 1995.

We limited our review to the internal control structure for the $1,157.2 million reported for the accounts receivable and property, plant, and equipment accounts, and the $469.5 million accounts payable because the accounts represented 98 percent of the distribution depots' assets and 73 percent of the depots' liabilities as reported on the Statement of Financial Position.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements, including the accompanying notes. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit included an assessment of the reasonableness of the financial data reflected in the Statement of Financial Position for the DLA Distribution Depots. We evaluated the procedures and controls that DFAS-Columbus Center and the DLA used to prepare the Statement of Financial Position.

This financial statement audit was made from April 1994 through March 1995. The audit entailed the use of computer-processed financial data and reports. We determined the reliability of the computer-processed data as related to the accounts reviewed. Organizations visited or contacted are in Appendix C.

Part II.A. - Review of Internal Controls

Introduction

We examined the internal control structure for selected financial data included in the Statement of Financial Position for the DLA Distribution Depots for the year ended September 30, 1994. The statement on which our examination was based was dated January 11, 1995. DFAS and DLA are jointly responsible for establishing and maintaining an internal control structure over the financial data used to prepare the DLA Distribution Depots' financial statements. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures.

According to United States Code, title 31, the objectives of an internal control structure are to provide management with reasonable but not absolute assurance that the following are met.

o Transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets.

o Funds, property, and other assets are safeguarded against loss, misappropriation, unauthorized use, and waste.

o Transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and any other laws and regulations that OMB, the entity management, or IG, DoD, have identified as being significant for which compliance can be objectively measured and evaluated.

Objectives and Scope

One objective of the audit was to determine whether material internal control weaknesses existed. In planning and performing our audit of selected accounts from the Statement of Financial Position for the DLA Distribution Depots, we evaluated the internal control structure within DFAS and DLA. The purposes of the evaluation were to determine:

o whether the internal control structure was established to ensure that the statement was free of material misstatements and

o the extent of auditing procedures and testing required for expressing an opinion on the financial statement.

The evaluation included obtaining an understanding of the internal control policies and procedures and assessing the level of control risk relevant to all significant cycles, classes of transactions, and account balances. For those significant internal control policies and procedures, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed. For the purposes of this report, we have classified the significant internal control policies and procedures into the following categories: fund balance with the Treasury; accounts receivable; accounts payable; property, plant, and equipment accounts; financial reporting; and transaction processing. We also evaluated the process by which DFAS and DLA management implemented the DoD Internal Management Control Program.

To ascertain the accuracy of the reported values for the selected Statement of Financial Position accounts (that is, accounts receivable; accounts payable; and property, plant, and equipment), we reviewed transactions affecting those accounts as a whole. We also selected a judgmental sample of primarily overage and high dollar accounts that comprise the accounts receivable and accounts payable balances. Our judgmental sample of accounts receivable consisted of 73 receivables of which 47 were valued at a positive $85.1 million and 26 were valued at a negative $17.5 million. The judgmental sample of 50 accounts payable included 33 payables valued at a positive $100.3 million and 17 payables valued at a negative $2.6 million.

The audit entailed the use of computer-processed financial data and reports. We determined the reliability of the computer-processed data as related to the accounts reviewed. We conducted our audit in accordance with generally accepted auditing standards, issued by the Comptroller General of the United States as implemented by the IG, DoD, and OMB Bulletin No. 93-06. Those standards require that we plan and perform audits to obtain reasonable assurance on whether the financial statements are free of material misstatements. We applied those standards to selected financial data included in the Statement of Financial Position for the DLA Distribution Depots.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions that are also considered to be material weaknesses.

Prior Audit Reports and Other Reviews

Since the inception of the DBOF in FY 1992, the General Accounting Office and the IG, DoD, have completed multiple audits related to DFAS and DLA management accounting controls. The audits identified the lack of internal

controls for preparing financial statements and weaknesses in accounting systems. The principal audits on DLA business areas of the DBOF are summarized in Appendix A.

Results of Audit

Reportable Conditions. Internal control weaknesses over DLA Distribution Depots financial data were material and reportable under DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect an organization's ability to effectively control and manage its resources and ensure accurate and reliable financial information needed to manage and evaluate operational performance. A material weakness is a reportable condition in which the design or operation of the internal control structure does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors would be in amounts that would be material to the statements being audited, or material to a performance measure or aggregation of related performance measures, and not be detected within a timely period by employees in the normal course of performing their functions.

Our examination of selected balance sheet accounts of the Statement of Financial Position for the DLA Distribution Depots showed that it contained material misstatements and omissions. DoD, DFAS, and DLA were aware of inherent accounting process and systems weaknesses that resulted in unreliable financial data. The control weaknesses were addressed in previous audit reports (see Appendix A). DoD, DFAS, and DLA reported the control weaknesses in their FY 1994 Annual Statements of Assurance as required by the DoD Internal Management Control Program. Further, financial statement inaccuracies were addressed in notes to the statements. However, corrective actions are not scheduled for completion before FY 1995 and beyond.

Financial Data, Internal Controls, and Notes

Conditions affecting the reliability of financial data, reportable internal control weaknesses, and notes to the financial statements are discussed in the following paragraphs.

Accounts Receivable and Accounts Payable. We could not ascertain the propriety of the $780.9 million reported for accounts receivable and the $469.5 million reported as accounts payable on the Statement of Financial Position for the DLA Distribution Depots. However, we ascertained that the following conditions affected the accounts.

o Unsupported and unverifiable increases of $303.9 million and $97.4 million were made to accounts receivable and accounts payable balances, respectively. The increases were made to balance the depots' financial records (that is, the general ledger) to the U.S. Treasury records for "undistributed" collections and disbursements. The practice, which is not in accordance with generally accepted accounting principles, was addressed previously in IG, DoD, Report No. 94-159, "Fund Balances with the Treasury Accounts on the FY 1993 Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund," June 30, 1994 (see Appendix A).

o Accounts receivable and accounts payable contained material amounts of overage accounts that could not be verified as valid because of the lack of supporting documentation. For example, our judgmental sample of 50 accounts payable, with an absolute value of $102.8 million, disclosed that 47 of the accounts payable, with an absolute value of $75.7 million, could not be verified as valid because of the lack of documentation.

o Accounts receivable and accounts payable contained material negative account balances. For example, the reported accounts receivable balance included 528 accounts with a combined negative value of $19.9 million. Accounts receivable and accounts payable should not contain negative balances. The negative account balances existed primarily because DFAS personnel processed collections and disbursements without matching them to valid document or job order numbers.

Property, Plant, and Equipment. The reported value of $376.3 million for property, plant, and equipment was materially understated because all real property facilities were not included. In response to IG, DoD, Report No. 94-149 (see Appendix A), DLA initiated corrective actions during FY 1994. DLA increased the value of the property, plant, and equipment account for the distribution depots by $176.4 million to more accurately account for the value of three of the depots' newest and largest centralized distribution facilities. However, full implementation and accurate reporting of the distribution depots' property, plant, and equipment values is not scheduled for completion until the end of FY 1995.

DFAS and DLA Internal Control Weaknesses and Notes to the Financial Statements. The conditions and causes disclosed during this audit were not new and have been reported in prior audits. DFAS has recognized and reported weaknesses in its financial accounting processes and systems. In the DFAS Annual Statement of Assurance for FY 1994, DFAS reported:

> Required reconciliations and analysis procedures are either untimely or nonexistent.
>
> There is a backlog of processed interfund bills. Correcting this weakness will eliminate the backlog of interfund bills over 120 days and improve the reliability of the financial statements.

> Three month backlog of disbursements and extensive backlogs in other functions of the Accounting Directorate has resulted in disbursements being understated in the General Ledger . . . backlogs in other areas including transactions for others, transactions by others, transactions by self, unprocessed accounts payable, aged accounts receivable, and negative unliquidated obligations balances. As a result of these backlog conditions, financial reports are not accurate.

Additionally, DLA recognized the unreliability of reported financial data in its FY 1994 financial statements and appropriately included qualifying comments in its Overview and footnotes to the financial statements. Specifically, DLA stated:

> Accounts receivable and accounts payable include "undistributed" amounts which represent differences between collections and disbursements . . . [DLA] has recognized the "undistributed" problem and is currently pursuing corrective actions.
>
> Accounts receivable and accounts payable include over-aged and negative amounts which are currently under investigation for system and processing deficiencies.
>
> DLA believes that the capital assets recorded in the general ledger are understated by a material amount. Distribution is currently pursuing milestones to properly reflect all capital assets in its financial statements, however, to date, has not recorded all property, plant and equipment for which it is responsible.

Summary

This is the third year that DFAS and DLA have produced and we have audited the DLA Distribution Depots' financial statements, as required by the Chief Financial Officers Act of 1990. During 1994, both DFAS and DLA initiated several actions to improve the financial data needed to produce reliable financial statements. DFAS reported its control weaknesses and has developed plans for correcting the identified weaknesses. DLA contracted with a private accounting firm to review its accounting processes and developed goals to improve its financial statements. Because the majority of the corrective measures that DFAS and DLA implemented are not scheduled for completion before the end of FY 1995 and beyond, we are not making additional recommendations at this time. Planned corrections to the accounting processes and system weaknesses should significantly improve the accuracy of reported financial data and usefulness of the financial statements.

Management Comments and Audit Response

We received comments on the draft report from the Office of the Under Secretary of Defense (Comptroller). The Deputy Chief Financial Officer stated that he agreed in principle with the findings in the report, except issues raised by our reference to a previous report on fund balance with the Treasury accounts. The complete text of the Deputy Chief Financial Officer's comments is in Appendix E.

In response to the comments received, we expanded our summation of the previously issued audit report (Appendix A, Report No. 94-159). The Defense Finance and Accounting Service and the DLA advised us that they will not be providing comments. Comments on this final report are not required.

Part II.B. - Review of Compliance with Laws and Regulations

Introduction

We evaluated selected financial data included in the Statement of Financial Position for the DLA Distribution Depots for material instances of noncompliance with laws and regulations for the year ended September 30, 1994. The Statement of Financial Position on which we based our evaluation was dated January 11, 1995. Such tests are required by the Chief Financial Officers Act of 1990.

Objectives and Scope

One of the objectives of the audit was to determine whether any material instances of noncompliance with laws or regulations existed. Material instances of noncompliance are failures to follow requirements, or violations of prohibitions in laws or regulations. Such failures or violations are those that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements or those of a sensitive nature that would cause them to be perceived as significant.

Compliance with laws and regulations applicable to the DLA Distribution Depots' financial data is the joint responsibility of DFAS and DLA. As part of obtaining reasonable assurance on whether the Statement of Financial Position is free of material misstatements, we tested compliance with laws and regulations that may directly affect the financial statement and other laws and regulations designated by OMB and DoD. The list of laws and regulations we reviewed is in Appendix B.

Prior Audit Coverage

Compliance issues related to financial data were addressed in the same audit reports discussed in Part II.A. of this report.

Results of Audit

The results of our tests indicate that with respect to the material items tested, except the noncompliance described in Part II.A. of this report, management complied with all laws and regulations listed in Appendix B. We considered the

instances of material noncompliance in forming our disclaimer of opinion on the selected financial data included in the Statement of Financial Position for the DLA Distribution Depots. With respect to items not tested, nothing was disclosed that caused us to believe that management had not complied, in all material respects, with the laws and regulations referenced above.

Part III - Additional Information

Appendix A. Summary of Prior Audits and Other Reviews

During the last 4 years, multiple audits have been performed relating to the Chief Financial Officers Act and financial statements of DBOF business areas. Since the inception of DBOF in FY 1992, the General Accounting Office and the IG, DoD, have completed multiple audits related to DFAS and DLA accounting controls. The audits identified the lack of internal controls for preparing financial statements and weaknesses in accounting systems. The principle audits related to the DLA business areas of the DBOF are summarized below.

IG, DoD, Report No. 94-167, "Selected Financial Accounts on the Defense Logistics Agency Defense Business Operations Fund Financial Statements for FY 1993," June 30, 1994, summarized the results of several reports on DLA financial statement accounts. The report provided an adverse opinion on the financial data examined and identified internal control weaknesses that were considered to be material and reportable conditions under standards established by OMB Bulletin No. 93-06. Audit trails were not adequate, reconciliations were not performed to support reported amounts, and transactions were not matched to the proper accounting period. Material instances of noncompliance with laws and regulations were also discussed. Requirements of the Federal Managers' Financial Integrity Act, the DoD Accounting Manual, and OMB and DoD guidance on the form and content of financial statements were not effectively implemented. The report contained no recommendations.

IG, DoD, Report No. 94-164, "Financial Statements of the Defense Reutilization and Marketing Service for FY 1993," June 30, 1994, stated that the FY 1993 financial statements for the Defense Reutilization and Marketing Service (DRMS) were not prepared in accordance with generally accepted accounting principles, and key asset, revenue, and expense accounts were not adequately supported or compiled in the financial records. As a result, the financial statements cannot be relied upon for assessing the DRMS financial position, results of operations, or performance. The report contained several recommended improvements to make the DRMS financial statements more accurate. DLA responded to all recommendations, partially concurring with developing a fee structure for services. DLA also agreed to make accounting changes, to restate the value of inventory and report the cost of goods sold at net realizable value, and to make necessary changes in the DRMS Internal Management Control Program.

IG, DoD, Report No. 94-159, "Fund Balances with the Treasury Accounts on the FY 1993 Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund," June 30, 1994, stated that fund balances with the Treasury accounts of DLA business areas were not prepared in accordance with generally accepted accounting principles for Federal agencies. This condition occurred because the DoD definition of fund balances did not meet OMB guidelines. Also, collection and disbursement data compiled by DFAS through the Appropriation Control and Reporting System

lacked audit trails and proper period matching procedures. As a result, presentation related to the DLA cumulative $1.04 billion for fund balance with the Treasury accounts in its FY 1993 statements of financial position, cash flow, and related footnotes were misleading and could not be relied upon by users of the financial statements. The report recommended that the then Comptroller of the DoD, guidance related to fund balance with the Treasury be rescinded because it was not in accordance with generally accepted accounting principles; that procedures and controls be issued to establish adequate audit trails, reconciliations, and controls over appropriation limits; that sublimits be established for business areas; and that discrepancies be disclosed in the FY 1993 statements of cash flow and accompanying footnotes. DLA concurred with the recommendation to establish appropriate sublimits for business areas, and partially concurred with the recommendation to disclose discrepancies in the FY 1993 statements of cash flow and accompanying footnotes. The Office of the Under Secretary of Defense (Comptroller) issued guidance on January 5, 1995, to make fund balance reporting more in line with OMB guidelines, and procedures to effect adjustments to general ledger accounts resulting from undistributed amounts were included in volume IIB of the DoD Financial Management Regulation.

IG, DoD, Report No. 94-158, "Cash Management Within the Defense Reutilization and Marketing Service," June 30, 1994, stated that the DFAS-Columbus Center retained in suspense accounts for DRMS pre-FY 1993 and FY 1993 sales proceeds for extended periods rather than releasing the proceeds to qualified recipients in a timely manner. As a result, the funds could not be used by the qualified recipients for operating purposes. The report recommended that DRMS immediately close pre-FY 1993 sales contracts and that the National Sales Office deposit all sales proceeds generated from sales of scrap material directly into the accounts of the qualified recipients. It also recommended that DRMS review and release FY 1993 sales proceeds to qualified recipients. DLA concurred with all recommendations, indicating that DRMS will take action to transfer all sales proceeds being retained in several suspense accounts maintained by the DFAS-Columbus Center to the accounts of qualified recipients; to immediately deposit all future sales proceeds generated from the sales of scrap material into the accounts of qualified recipients; and to identify and transfer all sales proceeds being retained by local finance offices to the accounts of qualified recipients.

IG, DoD, Report No. 94-150, "Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993," June 28, 1994, stated that general ledger accounts, nonfinancial records, and yearend accounting adjustments did not reflect the correct value of inventory under the control and management of DLA. As a result, the asset balances presented on the financial statements were misstated. The report recommended that procedures and controls be established to ensure that general ledger accounts, nonfinancial records, and yearend accounting adjustments reflect the correct value of inventory under the control and management of DLA. DLA concurred with the recommendations concerning inventory counts and support for inventory accounts, other than

stock on hand. The then Comptroller of the DoD concurred with the recommendations concerning inventory counts and support for inventory accounts, other than stock on hand.

IG, DoD, Report No. 94-149, "Property, Plant, and Equipment Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993," June 28, 1994, stated that DLA property, plant, and equipment account acquisition costs were materially understated by at least $229.4 million. Additionally, at least $24.5 million in equipment assets were inaccurately reflected in the financial records. The report recommended that the Director, DLA, establish procedures to more effectively identify and report capital assets and to reconcile capital asset data provided to the DFAS. DLA concurred with the recommendation to identify and report real property on its financial statements and the need to periodically reconcile property, plant, and equipment financial data with property records.

IG, DoD, Report No. 94-035, "Financial Reporting Procedures for Distribution Depots - Defense Logistics Agency Business Area of the Defense Business Operations Fund for FY 1992," February 8, 1994, addressed significant weaknesses in internal controls that affect the reliability of financial data presented in the financial statements. The report stated that property, plant, and equipment accounts for FY 1992 were significantly understated because not all real property assets had been reported. The report had no recommendations. However, the DoD Deputy Comptroller (Management Systems) commented on the report stating that real property used by DBOF activities should be reported as an asset on the financial statement of the using activity.

IG, DoD, Report No. 93-164, "Financial Statements of the Defense Logistics Agency Supply Management Division of the Defense Business Operations Fund (Defense Fuel Supply Center Financial Data) for FY 1992," September 2, 1993, stated that the inventory financial data were generally accurate; however, data in the financial statements were not properly supported, and information in the notes, overview, and supplemental financial and management information portions of the financial statements were incomplete and inaccurate. The report recommended that DLA develop procedures to ensure that financial data are reconciled, supported and accurate; that the financial statements are revised to include all required notes and supplemental information; and that the financial statements are reliable and accurate. DLA nonconcurred with some of the noninventory findings and recommendations and stated that adjustments and disclosures identified would not be made to the FY 1992 data presented in the FY 1993 financial statements and related notes.

IG, DoD, Report No. 92-129, "Defense Stock Fund Financial Statements (Materiel Managed Under the Standard Automated Material Management System) for FY 1991," August 26, 1992, identified needed accounting adjustments to the original FY 1991 financial statements, including adjustments increasing the inventory financial data by $18 million. Additionally, the financial statements did not contain footnote disclosures related to inventory restrictions and unsupported account balances; and problems were identified with the physical inventory process. The report recommended that Defense Fuel Supply Center improve its accounting procedures, reconcile financial

inventory data with stock records, and establish cutoff procedures to ensure that transactions are recorded in the proper accounting period. The Defense Fuel Supply Center concurred with the recommended changes to the financial statements. However, it disagreed with our qualified opinion on the Standard Automated Material Management System inventory and nonconcurred with recommendations to improve the Defense Fuel Supply Center accounting procedures.

Appendix B. Laws and Regulations Reviewed

United States Code, title 31 (formerly the Federal Managers' Financial Integrity Act of 1982, Public Law 97-255)

Chief Financial Officers Act of 1990, Public Law 101-576

Office of Management and Budget, "Statement of Federal Financial Accounting Concepts, Number 1, Objectives of Federal Financial Reporting," September 2, 1993

Office of Management and Budget, "Statement of Federal Financial Accounting Standards, Number 1, Accounting for Selected Assets and Liabilities," March 30, 1993

Office of Management and Budget, "Statement of Federal Financial Accounting Standards, Number 3, Accounting for Inventory and Related Property," October 27, 1993

Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993

Office of Management and Budget Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993

Office of Management and Budget Circular No. A-127, "Financial Management Systems," December 19, 1984

Office of Management and Budget Circular No. A-123, "Internal Control Systems," August 4, 1986

"DoD Guidance on Form and Content of Financial Statements for FY 1994 and FY 1995 Financial Activity," October 20, 1994

DoD Manual 7220.9-M, "DoD Accounting Manual," October 1983

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987

DoD Directive 7200.1, "Administrative Control of Appropriations," revised July 27, 1987.

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," May 1993.

Defense Logistics Agency Manual 7000.1, "Accounting and Finance Manual," August 1980

Appendix C. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller), Washington, DC

Defense Logistics Agency

Headquarters, Defense Logistics Agency, Alexandria, VA
Defense Construction Supply Center, Columbus, OH
Defense General Supply Center, Richmond, VA
Defense Distribution Region East, New Cumberland, PA
- Defense Distribution Depot, Albany, GA
- Defense Distribution Depot, Anniston, AL
- Defense Distribution Depot, Charleston, SC
- Defense Distribution Depot, Cherry Point, NC
- Defense Distribution Depot, Columbus, OH
- Defense Distribution Depot, Jacksonville, FL
- Defense Distribution Depot, Letterkenny, PA
- Defense Distribution Depot, Norfolk, VA
- Defense Distribution Depot, Richmond, VA
- Defense Distribution Depot, Tobyhanna, PA
- Defense Distribution Depot, Warner Robins, GA

Defense Distribution Region West, Stockton, CA
- Defense Distribution Depot, Barstow, CA
- Defense Distribution Depot, McClellan, CA
- Defense Distribution Depot, Oakland, CA
- Defense Distribution Depot, Ogden, UT
- Defense Distribution Depot, Puget Sound, WA
- Defense Distribution Depot, Red River, TX
- Defense Distribution Depot, San Antonio, TX
- Defense Distribution Depot, San Diego, CA

Headquarters, Defense Reutilization and Marketing Service, Battle Creek, MI

Defense Finance and Accounting Service

Headquarters, Defense Finance and Accounting Service, Washington, DC
Defense Finance and Accounting Service, Columbus Center, Columbus, OH

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
  Deputy Under Secretary of Defense (Comptroller/Management)
  Deputy Under Secretary of Defense (Comptroller/Program/Budget)
Assistant to the Secretary of Defense (Public Affairs)
Director, Defense Logistics Studies Information Exchange

Department of the Army

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

Department of the Navy

Assistant Secretary of the Navy (Financial Management)
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

Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, Defense Finance and Accounting Service
Director, Defense Finance and Accounting Service, Columbus Center
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Central Imagery Office

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
National Security and International Affairs Division, General Accounting Office
  Technical Information Center
  Defense and National Aeronautics and Space Administration Management Issues
  Military Operations and Capabilities Issues

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

Office of the Under Secretary of Defense (Comptroller) Comments

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

COMPTROLLER

APR 17 1995

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Draft of a Proposed Audit Report "Statement of Financial Position for the Defense Logistics Agency Distribution Depot Business Area of the Defense Business Operations Fund, as of September 30, 1994" (Project No. 4LD-2007 dated March 24, 1995)

This is in response to summary finding in the subject draft report. Additional responses will be provided by the Defense Logistics Agency (DLA) and the Defense Finance and Accounting Service (DFAS), as appropriate.

With one exception, the Department agrees in principle with the findings noted in the report. That exception is the second full paragraph (first bullet) on page 13 beginning with the words "Unsupported and unverifiable...." While the statement that the practice previously was reported in IG, DoD, Report No. 94-159 is basically correct, Appendix A of the draft report incorrectly cites a finding from the FY 1993 audit report. The correct reference in the FY 1993 audit report is located on page 11, entitled "Matching Procedures"--not "Adequacy of Definition" on page 9. In addition, on January 5, 1995, the Department issued guidance to address the "Adequacy of Definition" deficiency noted in Report No. 94-159. A copy of that guidance is attached for your information. Lastly, procedures to effect adjustments to general ledger accounts resulting from undistributed amounts are included in Volume 11B of the "DoD Financial Management Regulation" (DoD 7000.14-R), Chapter 54, paragraphs 9.a. and 9.e.

My point of contact on this matter is Mr. Oscar Covell. He may be reached at (703) 697-6149 or DSN 227-6149.

Alvin Tucker
Deputy Chief Financial Officer

Attachment

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

COMPTROLLER

JAN 5 1995

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE COMMISSARY AGENCY
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
DIRECTOR, DEFENSE INFORMATION SUPPORT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY
COMMANDER-IN-CHIEF, UNITED STATES TRANSPORTATION COMMAND
COMMANDER, JOINT LOGISTICS SYSTEMS CENTER

SUBJECT: Defense Business Operations Fund (DBOF) Cash Management Responsibility

The DBOF cash management policy has been established, and the FY 1995 budget provided for the return of a rational cash position after the excessive cash transfers directed by the Congress in FY 1993. The cash management policy defines the Components' role in cash management, making it clear that cash transactions are an integral part of operational management. However, in order to achieve the full benefit of the incentives provided by vigorous cash management, effective February 1, 1995, cash and its associated anti-deficiency limitations will be distributed to each Component. This will provide business area managers additional control of their operations.

The attachment provides the DBOF cash distribution for each Component. Based on FY 1995 and FY 1996 budget formulation rates and operating plans, it should be possible to maintain adequate cash balances. However, the Components should advance bill as necessary to remain solvent. Any advance billing should be reported to the Directorate for Revolving Funds monthly.

John J. Hamre

Attachment

PROPOSED DISTRIBUTION OF CASH
($ IN MILLIONS)

SERVICE/AGENCY	CASH TO BE DISTRIBUTED
ARMY	346
NAVY	442
AIR FORCE	129
DEFENSE AGENCIES 1/	600
TRANSCOM 1/	74
CORPORATE 2/	100
GRAND TOTAL	1,691

1/ Defense Agencies and TRANSCOM operating cash levels do not include the DeCA appropriation and subsidy payment, respectively, which are made at the beginning of the year and provide additional flexibility.

2/ It is anticipated that Corporate will cease to exist in FY 1996. It will be used in FY 1995 to pay non-DoD bills incurred prior to cash distribution.

Audit Team Members

This report was produced by the Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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