

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

MAJOR DEFICIENCIES PREVENTING AUDITORS FROM
RENDERING AUDIT OPINIONS ON FY 1995 DOD
GENERAL FUND FINANCIAL STATEMENTS

Report No. 97-026

November 19, 1996

Department of Defense

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Acronyms

AAA	Army Audit Agency
AICPA	American Institute of Certified Public Accountants
CFO	Chief Financial Officers
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
FASAB	Federal Accounting Standards Advisory Board
GFP	Government Furnished Property
IG	Inspector General
OMB	Office of Management and Budget
SFAS	Statement of Financial Accounting Standard
SFFAS	Statement of Federal Financial Accounting Standard
USD(C)	Under Secretary of Defense (Comptroller)



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November 19, 1996

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
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MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE
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DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE
COMMANDER, U.S. ARMY CORPS OF ENGINEERS
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Audit Report on Major Deficiencies Preventing Auditors From Rendering
Audit Opinions on FY 1995 DoD General Fund Financial Statements
(Report No. 97-026)

We are providing this audit report for review and comments. It identifies and summarizes the major deficiencies that prevent auditors from rendering audit opinions on the FY 1995 DoD General Fund financial statements. It also identifies and summarizes actions taken or under way to correct these deficiencies. Although comments on the draft report were not required, the Under Secretary of Defense (Comptroller) provided comments that took exception to several conclusions in the report. These comments were considered in preparing the final report.

Comments on this report met the requirements of DoD Directive 7650.3, but left two unresolved issues: the basis of accounting hierarchy and accounting policy for contingent liabilities. DoD Directive 7650.3 requires that all unresolved issues be resolved promptly. We request that the Under Secretary of Defense (Comptroller) reconsider the positions taken on the two unresolved issues and provide additional comments by January 20, 1997.

We appreciate the courtesies extended to the audit staff. Questions about this audit should be directed to Mr. Richard B. Bird, Audit Program Director, at (703) 604-8868 (DSN 664-8868), or Mr. John J. Vietor, Audit Project Manager, at (317) 542-3855 (DSN 699-3855). The distribution of this report is listed in Appendix H. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. 97-026
(Project No. 5FI-2012.04)

November 19, 1996

Major Deficiencies Preventing Auditors From Rendering Audit Opinions on FY 1995 DoD General Fund Financial Statements

Executive Summary

Introduction. This report summarizes major deficiencies impeding the ability of DoD to produce auditable General Fund financial statements and gives Congress, the Secretary of Defense, the DoD Chief Financial Officer, financial managers, and the audit community an assessment of progress made in audited financial statements of DoD General Funds. The FY 1995 DoD General Fund financial statements consist of Army and Air Force General Funds. The Navy's and Defense agencies' General Fund financial statements are not required to be prepared until FY 1996. This is the second annual report on deficiencies that prevent auditors from rendering audit opinions on DoD General Funds.

Audit Objective. The audit objectives were to identify and summarize major deficiencies that prevented auditors from rendering audit opinions on FY 1995 DoD General Fund financial statements, and to identify actions taken or under way to correct these deficiencies.

Audit Results. Auditors identified several major deficiencies that prevented them from rendering audit opinions on FY 1995 DoD General Fund financial statements. The overarching deficiency was the lack of adequate accounting systems for compilation of accurate and complete financial data. Specifically, Army and Air Force Audit Agencies were unable to render audit opinions on their Military Departments' FY 1995 General Fund financial statements because of inadequate accounting systems; a lack of audit trails; unsupported amounts for several types of assets, liabilities, and expenses; unreliable financial information; and poor internal controls. The audit agencies were not able to apply other auditing procedures in these areas to satisfy themselves as to the fairness of data presented in FY 1995 DoD General Fund financial statements. Auditors have been disclaiming opinions on Army and Air Force General Fund financial statements since FY 1991 and FY 1988, respectively.

DoD managers have acknowledged significant problems with financial data and have taken actions to improve data used to compile Army and Air Force General Fund financial statements. The Army and the Defense Finance and Accounting Service (DFAS) have made progress in resolving military pay control weaknesses and in reducing unmatched disbursements, negative unliquidated obligations, and outstanding travel advances. The Air Force and DFAS have begun efforts to coordinate systems work, improve controls over the obligation process, reduce time required to reconcile problem disbursements, and increase accuracy of Air Force payroll data. However, DFAS has made minimal progress in correcting accounting system deficiencies to comply with the 13 key accounting requirements. DFAS is continuing its attempts to develop adequate accounting systems for General Funds by evaluating its options and solutions for a General Fund accounting system. Noteworthy progress was made when the Under Secretary of Defense (Comptroller) designated the Corps of Engineers

Financial Management System as the migratory accounting system for Army and Air Force General Fund accounting. Until DFAS finalizes and begins to execute design and deployment plans for the Corps of Engineers Financial Management System, we cannot estimate when auditable DoD General Fund and DoD Consolidated Financial Statements can be prepared using accounting system data. Therefore, disclaimers of opinion can most likely be expected until the next century for the Military Departments' General Fund financial statements as well as DoD Consolidated Financial Statements. Despite these obstacles, the Army Audit Agency, with cooperation from Army leadership, is considering a plan to audit the Army General Fund by reviewing data available from systems other than deficient DFAS accounting systems, and will attempt to render an audit opinion on the FY 1997 Statement of Financial Position. This effort will require a substantial commitment of resources from both management and auditors. In addition, DoD implementation of the Federal Accounting Standards Advisory Board's accounting standards may partially eliminate some major obstacles that prevent auditors from rendering opinions on the Military Departments' General Fund financial statements. This summary report contains no recommendations because needed recommendations were made in other audit reports. This report is intended to help Congress and DoD assess the progress toward successful implementation of the Chief Financial Officers Act and preparation of auditable General Fund financial statements.

Management Comments. We issued a draft of this report on June 28, 1996, which contained no recommendations subject to resolution under DoD Directive 7650.3. Therefore, management comments were not required. However, we received comments from the Under Secretary of Defense (Comptroller) that took exception to our conclusion that disclaimers of opinions can be expected "well into the next century" for the Military Departments' General Fund financial statements. He also disagreed with our conclusions that the DoD basis of the accounting hierarchy and accounting policy for contingent liabilities prevented the Army Audit Agency from rendering an audit opinion on Army General Fund financial statements. The Under Secretary of Defense (Comptroller) stated that his policies are consistent with the hierarchy of accounting principles and standards issued by the Office of Management and Budget. He also stated that DoD policies for recording contingent liabilities mirror the requirements in Office of Management and Budget Bulletin 94-01, "Form and Content of Agency Financial Statements," November 29, 1993. See Part I for a complete discussion of management's comments and Part III for complete text of these comments.

Audit Response. We have reconsidered the appropriateness of the phrase "well into the next century" and acknowledge that the phrase is not entirely clear. Since requisite systems will not be in place before FY 2002 and the Under Secretary of Defense (Comptroller) agrees that opinions other than disclaimers of opinion cannot be expected in the near term, the point is that favorable opinions are not imminent. We have changed "well into the next century" to "most likely until the next century." We remain convinced that our conclusions on the basis of accounting hierarchy and accounting policy for contingent liabilities are fully supported. If the Under Secretary of Defense (Comptroller) continues to maintain these positions, it will make it very difficult to attain a qualified or unqualified opinion on the Military Departments' General Fund financial statements or on the DoD Consolidated Financial Statements. Part I explains the reason for our position. We request that the Under Secretary of Defense (Comptroller) reconsider positions taken on the two issues and provide additional comments by January 20, 1997.

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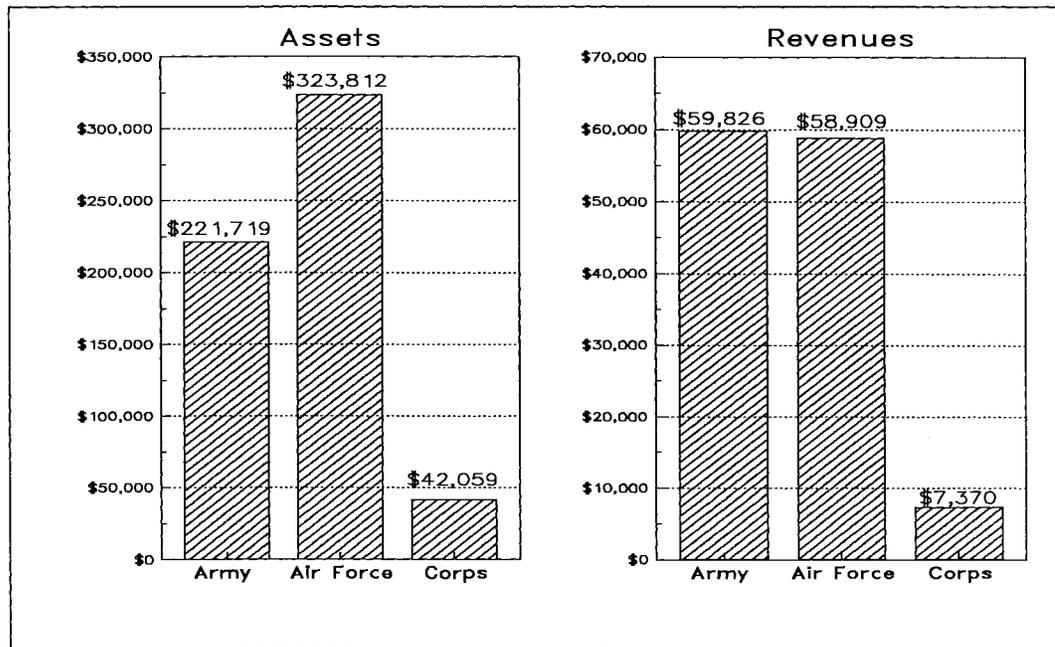
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Part I - Audit Results

Audit Background

Public Law. Public Law 101-576, the Chief Financial Officers (CFO) Act of 1990, November 15, 1990, requires the annual preparation and audit of financial statements for trust funds, revolving funds, and substantial commercial activities of Executive departments. The Office of Management and Budget (OMB) has designated organizations, including the Departments of the Army and the Air Force, to prepare financial statements. The OMB has not required audited financial statements for the Department of the Navy or other Defense agencies. The CFO Act requires the Inspector General (IG), or appointed external auditors, to audit the financial statements in accordance with generally accepted Government auditing standards and other standards established by the OMB. The IG, DoD, and the auditors of the Military Departments, under the cognizance of the IG, DoD, conducted these audits. Public Law 103-356, the Government Management Reform Act of 1994, October 13, 1994, requires DoD to issue agency-wide audited financial statements beginning in FY 1996 and annually thereafter. Agencies must submit their audited financial statements for FY 1996 to OMB by March 1, 1997.

Magnitude of Assets. DoD prepared General Fund financial statements for FY 1995 for three major activities: the Army, the Air Force, and the U.S. Army Corps of Engineers, Civil Works Program. The FY 1995 financial statements of the Army, the Air Force, and the U.S. Army Corps of Engineers, Civil Works Program, included assets of more than \$587 billion and revenues of more than \$126 billion. The figure below shows the relationships between assets and revenues of the Army, the Air Force, and the U.S. Army Corps of Engineers. Appendix D summarizes financial data from the FYs 1994 and 1995 Statements of Financial Position and Statements of Operations for the Army, the Air Force, and the U.S. Army Corps of Engineers, Civil Works Program.



FY 1995 Assets and Revenues for the Army, the Air Force and the U.S. Army Corps of Engineers, Civil Works Program (in Millions)

Audit Opinions. The objective of a financial statement audit by an independent auditor is to render an audit opinion. The opinion is based on the auditor's determination of whether or not the financial statements present fairly, in all material respects, the financial position, results of operations, and the cash flows of the organization being audited. The audit includes a review of conformity with generally accepted accounting principles. Auditors use the audit report to render an audit opinion or, if required, to disclaim an opinion. Auditors can render three types of audit opinions.

- o Unqualified opinion: an unqualified opinion states that the financial statements are presented fairly.

- o Qualified opinion: a qualified opinion states that, except for stated qualifications, the financial statements are presented fairly.

- o Adverse opinion: an adverse opinion states that the financial statements are not fairly presented.

When auditors cannot conduct an audit, they issue a disclaimer of opinion. A disclaimer states that the auditor is not rendering an opinion on the financial statements, and is appropriate when auditors have not performed an audit sufficient in scope to enable them to form an opinion on the financial statements. Restrictions on the scope of an audit, whether imposed by the client or the circumstances, may result from limitations on the timing of work, the inability to obtain sufficient evidence, or the inadequacy of accounting records.

Audit Results

Previous Financial Statement Audits of DoD General Funds. Financial statement audits of DoD general funds have been performed since FY 1988. Disclaimers of opinion have been rendered on the Army and the Air Force General Fund financial statements. Although auditors have reviewed the overall financial statements and disclaimed opinions on them, the focus of the previous audits was the Statement of Financial Position.

Army General Fund Financial Statements. The General Accounting Office disclaimed opinions on the FYs 1991 and 1992 Army General Fund financial statements. The Army Audit Agency (AAA) disclaimed opinions on the FYs 1993 through 1995 financial statements.

Air Force General Fund Financial Statements. The General Accounting Office disclaimed opinions on the FYs 1988 and 1989 Air Force General Fund financial statements. The Air Force Audit Agency disclaimed opinions on the FYs 1992 through 1995 financial statements.

U.S. Army Corps of Engineers, Civil Works Program. The financial statements of the U.S. Army Corps of Engineers, Civil Works Program, were audited by the General Accounting Office in FYs 1991 and 1992 and by the AAA in FY 1993 as part of the Army's General Fund financial statements. Opinions were disclaimed in each of those years. Beginning in FY 1994, DoD required separate financial statements and a separate audit opinion for the U.S. Army Corps of Engineers, Civil Works Program. The AAA disclaimed an opinion on the FY 1994 financial statements of the U.S. Army Corps of Engineers, Civil Works Program. The AAA did not attempt to render an opinion on the FY 1995 financial statements of the U.S. Army Corps of Engineers, Civil Works Program.

Navy General Fund Financial Statements. DoD has not yet prepared the Navy's General Fund financial statements for audit by independent auditors. Beginning in FY 1996, the Naval Audit Service, as designated by the IG, DoD, will conduct the first audit of the Navy General Fund.

Defense Agencies' General Fund Financial Statements. The Defense agencies have not yet prepared financial statements. As a result of the Government Management Reform Act of 1994, Defense agencies will be required to prepare FY 1996 financial statements. However, those statements will not be audited annually. Rather, the IG, DoD, plans to audit internal controls and compliance with laws and regulations within the Defense agencies. The IG, DoD, will also provide audit coverage of the Defense agency financial information in the "Other Defense" category of the DoD Consolidated Financial Statements. This audit approach, agreed to by the Chief Financial Officer of DoD, is based on the materiality of the "Other Defense" category in relation to the DoD Consolidated Financial Statements. The financial statements of specific Defense agencies may also be audited as needed. See Appendix C for a list of audit reports that have been issued for the FYs 1993, 1994, and 1995 General Fund financial statements.

Audit Objective

The objective of the audit was to identify and summarize the major deficiencies that prevented auditors from rendering audit opinions other than disclaimers on the FY 1995 DoD General Fund financial statements, and to identify the actions taken or under way to correct these deficiencies. See Appendix A for a discussion of the scope and methodology, and Appendix B for a summary of prior coverage related to the audit objective.

Major Deficiencies Preventing Auditors From Rendering Audit Opinions on FY 1995 DoD General Fund Financial Statements

Auditors have been unable to render audit opinions on the DoD General Fund financial statements since calendar year 1990, when the first disclaimer of opinion was issued on the FY 1988 Air Force Consolidated Financial Statements. We reviewed the reasons that auditors could not render an audit opinion on the FY 1995 DoD General Fund financial statements. We determined that among numerous issues reported by the auditors, inadequate accounting systems were the major deficiency preventing auditors from rendering audit opinions. This finding summarizes those deficiencies and discusses the actions taken or under way to correct them.

Reasons for Disclaimer

Army General Fund. The auditors were unable to render an opinion on the FY 1995 Army General Fund financial statements. The main reasons for the disclaimer of opinion were inadequate accounting systems, lack of audit trails, and unsupported amounts for several types of assets, liabilities, and expenses. Auditors were unable to apply other auditing procedures in these areas to satisfy themselves as to the fairness of the data presented. A brief discussion of each of the main reasons for disclaimers follows.

Accounting Systems. Deficiencies in the Army's accounting systems are the major reason auditors were unable to render an audit opinion. The accounting systems do not have integrated, transaction-driven general ledgers. Consequently, data for physical assets in the Army's financial statements are compiled using alternative procedures and information from management systems that are not intended and not suitable for financial reporting. The accounting systems also do not produce account-oriented transaction files or subsidiary ledgers. Therefore, the audit trails needed to verify the values reported for cash-based accounts on the Army's financial statements do not exist, and the balances on these statements are not auditable.

Government Furnished Property. The Army's accounting systems do not adequately capture the value of Government property furnished to contractors. In prior reports, auditors recommended that the Army use contractor reports as an alternate source for reporting the value of Government furnished property (GFP). Because the data in these reports was prepared from the accountable records maintained by contractors, auditors concluded that it was more representative than the figures available from the Army's accounting systems. The Army agreed to use the contractors' reports, but for FY 1995, it

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did not enter the value of property related to Army-administered contracts into the DoD database for GFP. As a result, the database contained contractor-reported amounts only for the Army's DoD-administered contracts, and the total value reported for GFP on the FY 1995 Army General Fund financial statements was misstated. Auditors could not determine the exact amount of the misstatement, but a comparison of the amounts reported in FYs 1994 and 1995 gave an indication. In FY 1994, using all of the contractors' reports, the Army reported about \$15.5 billion for GFP. The amount reported for FY 1995 was about \$8.3 billion.

Unit and Installation Property. The Army's accounting systems did not capture the values of equipment and real property owned by field units and installations. Instead, the values reported in the Army's financial statements for unit and installation-owned assets were derived from asset management and physical accountability systems. However, the data in these systems was not complete or accurate. As a result, auditors could not verify the values reported on the FY 1995 Army General Fund financial statements for equipment in the possession of units (about \$82.6 billion), real property (about \$34.6 billion), and unit assets in transit (about \$500 million).

Wholesale Assets. The data in the accounting systems for wholesale assets were not complete or accurate. Excluding munitions, wholesale assets reported on the FY 1995 Army General Fund financial statements (assets in storage at depots; assets in transit between contractors, depots, and using units; and assets on loan to other Government entities) totaled about \$23.7 billion. The accounting system data for these assets were not used for financial reporting, or were used to report asset values but were not auditable or consistent. The accounting system data were not reliable or auditable because inventory transactions sometimes were not properly processed, and transactions rejected by the accounting systems often were not properly resolved. This occurred in part because logistics and financial personnel were not sufficiently knowledgeable on how their processes and systems interact.

Equipment Awaiting Repair. The reported value for unserviceable equipment awaiting repair was overstated. These assets were reported at full standard price (about \$14.3 billion) in the inventory system, but their value should have been reduced by the estimated repair costs. Auditors reported this problem last year for the FY 1994 statements, and the Army agreed to reduce the equipment balance by the estimated repair costs. However, sufficient corrective action was not taken. Defense accounting offices were informed of the need to revalue the assets, but Army commodity commands were not directed to calculate estimated repair costs. As a result, the unserviceable assets were still valued at full standard prices. Auditors could not determine the amount of the understatement, but at two of the commands audited, maintenance costs were projected at \$729 million for a 5-year period. The full value of the unserviceable repairables at these two commands was \$3.9 billion.

Preparation of Statements. The Defense Finance and Accounting Service (DFAS) had improved its process for preparing the financial statements. Existing controls were generally enforced, and additional automated procedures were used to analyze and evaluate the data. Detailed reviews identified and

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explained unexpected balances for some accounts, especially the physical asset accounts. However, DFAS did not adequately address or could not explain differences in several cash-based account balances. Consequently, unexplained differences existed between some account balances reported on the Army's Statement of Financial Position for FYs 1994 and 1995. For example, advances and prepayments to Federal agencies decreased from \$641 million to \$90 million; accounts payable to non-Federal agencies increased from \$64 million to \$1.3 billion. Auditors did not examine these differences in detail, but the differences indicate potential problems.

Basis of Accounting. OMB Bulletin 94-01, "Form and Content of Agency Financial Statements," specifies the form and content of financial statements prepared to meet the requirements of the CFO Act. This bulletin incorporates a hierarchy of accounting principles to be used until a comprehensive set of accounting standards is issued by the Director, OMB, and the Comptroller General of the United States. In conflict with this policy, the Under Secretary of Defense (Comptroller) requires the Army to prepare its financial statements according to a hierarchy that begins with the "DoD Guidance on Form and Content of Financial Statements." The DoD guidance and the OMB guidance differ in several areas, such as accounting terminology, the reporting of fund balances with Treasury, the reporting of war reserves, and the reporting of contingent liabilities. Because the other conditions discussed above necessitated a disclaimer, auditors did not perform detailed audit work to quantify the effect of the DoD guidance.

Contingent Liabilities. DoD policy prevented the Army from following OMB reporting requirements for probable contingent liabilities. Consequently, a significant amount of liabilities was not recorded on the Army's Statement of Financial Position. As of September 30, 1995, the Army estimated its probable contingent liabilities at \$14.6 billion, and this amount was disclosed in the footnotes. However, the Army had not developed and implemented procedures to ensure that all such liabilities are identified, and it acknowledged that additional liabilities probably exist. In addition, for the past 2 years, the Army has estimated its probable contingent liabilities at \$25 billion. Although the footnotes did not provide specific information to explain the \$10 billion reduction for FY 1995, auditors were informed that the reductions occurred because DoD funds would be used for one of the major cost categories and because revised cost estimates were lower for other categories. Because DoD policy prohibited the recording of contingent liabilities, auditors did not conduct detailed audit tests to verify the reasonableness of the Army's estimates or its conclusions on responsibility for funding. However, the liabilities on the Statement of Financial Position will continue to be misstated until DoD changes its policy.

Summary. The Army continues to have major problems with financial reporting. The most significant of those problems, inadequate accounting systems, severely limited the auditors' scope and caused them to issue a disclaimer of opinion on the FY 1995 Army General Fund financial statements.

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Air Force General Fund. Auditors could not obtain sufficient evidence or apply other auditing procedures to satisfy themselves as to the fairness of the FY 1995 Air Force General Fund financial statements. As a result, they could not render an opinion on the reliability of the FY 1995 Air Force General Fund financial statements. Financial information was not reliable; also, financial systems and processes, as well as the associated internal control structure, did not produce reliable financial information. Auditors found account overstatements of \$2.4 billion and understatements of \$2.1 billion. As in previous years, auditors could not verify the acquisition cost of assets, valued at \$258.4 billion, because of system problems and document retention practices. The difficulties experienced by the auditors were further compounded by the lack of a transaction-driven general ledger. Auditors identified \$109 million in errors in Air Force inventory systems based on incorrect on-hand balances and unit pricing problems. Assets continue to be counted twice or excluded from account balances, and unserviceable assets are recorded at their full value. In addition, several of the conditions that caused auditors to disclaim opinions for FYs 1992 through 1994 still existed. Prior audit reports on the Air Force financial statements identified a number of conditions that prevented auditors from rendering opinions on the reliability of those financial statements. In the FY 1995 audit, the following conditions still existed.

- o The Air Force did not have a transaction-driven general ledger.
- o Accounting systems could not produce auditable financial statements.
- o Equipment and inventories were not reported accurately.
- o Account balances for disbursements and collections were questionable.
- o Acquisition costs were not used for most assets.

Auditors found significant conditions that adversely affected four of the five management assertions defined by generally accepted Government auditing standards. The following are details of the conditions that affected management's assertions.

Valuation or Allocation. Auditors identified several conditions that related to the appropriateness of amounts included in the financial statements for asset, liability, revenue, and expense accounts. For example, auditors could not determine the accuracy of financial statement balances for property, plant, and equipment, or for operating materials and supplies, because the Air Force did not have a financial accounting system designed to accumulate, account for, and report the acquisition costs of these assets. Also, the Air Force used standard costs to value these assets instead of using acquisition costs, as required by Government accounting standards. The GFP balance reported by the DFAS Denver Center in the FY 1995 Air Force General Fund financial statements was \$33.9 billion less than the values reported by contractors. This condition occurred because Air Force systems are inadequate to record, track, and report GFP owned by the Air Force and in the custody of contractors. In addition, auditors discovered disbursement and collection mismatches between the DFAS

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Denver Center's records and subsidiary data from Defense accounting offices. The number and value of disbursement and collection discrepancies, in conjunction with other reported fund control deficiencies, showed that data on fund control are not a reliable source of information for financial statement account balances. The Air Force did not capitalize \$673.4 million of satellite launch costs, which resulted in a corresponding understatement on the initial financial statements. Auditors could not determine the exact cause of this occurrence, and Air Force personnel were unable to reconstruct their calculations of satellite launch costs or refute auditors' calculations of those costs. Also, auditors continue to identify errors in on-hand balances and unit prices recorded in Air Force inventory systems.

Existence or Occurrence. Auditors identified several significant conditions related to whether all assets and liabilities included in the financial statements as of September 30, 1995, existed at that date, and whether all recorded transactions had occurred within the fiscal year ending on that date. For example, two Air Force sources reported to the DFAS Denver Center the same assets valued at over \$1 billion. As a result, the DFAS Denver Center included the reported amounts twice in the initial financial statements. The Air Force overstated satellites reported to the DFAS Denver Center because installation personnel double-counted a satellite valued at \$396.9 million. The Air Force reported munitions inventories in two different inventory system account balances, overstating assets by \$589 million. Some system assets, valued at \$39 million, were also counted twice by Air Force personnel. In FY 1996, at five locations, accounting personnel recorded progress payments of \$208.5 million and recoupments of progress payments of \$520.8 million that had occurred in FY 1995. As a result, the DFAS Denver Center overstated progress payments in the FY 1995 Air Force General Fund financial statements by \$312.3 million. Also, \$227 million of accounts receivable, accounts payable, expenses, and obligations were either invalid, inadequately supported, or inaccurate.

Completeness of Accounts. Auditors identified significant conditions concerning the completeness of data included in the FY 1995 Air Force General Fund financial statements. The Air Force did not report approximately \$3.2 billion of Air Force-owned munitions to the DFAS Denver Center for inclusion in the initial financial statements. Also, by failure to include the value of recently declassified U-2 aircraft in the aircraft balances forwarded to the DFAS Denver Center, the Air Force supplied the DFAS Denver Center with erroneous data for inclusion in the FY 1995 Air Force General Fund financial statements. As a result, assets were understated by \$572 million. Also, the Air Force did not report to the DFAS Denver Center \$527 million in excess and surplus property.

Presentation and Disclosure. Auditors identified several conditions related to the way the sections of the financial statements were classified, described, and disclosed.

o The DFAS Denver Center and Air Force personnel significantly improved contingent liability reporting for FY 1995. However, in the initial financial statements, auditors identified reporting errors that affected

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the accuracy of environmental cleanup liabilities, claims and litigation, future funding requirements, and procurement contract liabilities. For example, in the footnotes to the financial statements, the DFAS Denver Center presented outdated and unclear information on environmental cleanup liabilities. This reporting error occurred because the Air Force had provided the DFAS Denver Center with cost data from an incorrect fiscal year. In the footnotes to the financial statements, DFAS Denver Center did not disclose all information on claims and litigation. DFAS Denver Center personnel did not know that the footnotes were unclear. As a result, the financial statement did not give readers a clear presentation of Air Force claims and litigation. The DFAS Denver Center also overstated contingent liabilities by more than \$1.5 billion; this was done by including unfunded accrued military and civilian leave (\$1.58 billion) and allowances for uncollectible accounts (\$5.2 million) that did not meet the definition of contingent liabilities. Auditors also identified \$44.7 million of procurement contract incentive fees and other contract contingent liabilities at five Defense accounting offices. The Air Force may be liable for those amounts, but the DFAS Denver Center did not disclose the amounts in the financial statements.

- o During the FY 1995 audit, auditors determined that the DFAS Denver Center had included T56 and F100 engine modules, valued at \$914 million, in both the General Fund and the Defense Business Operations Fund FY 1994 financial statements.

- o Personnel at four of five Defense accounting offices included at least \$137.9 million of unmatched and possibly invalid recoupments in balances for progress payments on weapon systems. As a result, unmatched recoupments were not fully disclosed, and the balances on the financial statements may have been significantly understated.

- o The Air Force maintained excess and unserviceable aircraft and engines in inventory systems that feed general ledger accounts for operational assets, rather than in general ledger accounts for excess and surplus property assets. As a result, the DFAS Denver Center overstated the value of military equipment in the initial financial statements by \$288.3 million, with a corresponding understatement of operating materials and supplies.

- o In presenting the composition of the property, plant, and equipment line item in the footnotes to the initial financial statements, the DFAS Denver Center included \$283.8 million of real property under military equipment instead of under structures, facilities, and leasehold improvements. These deficiencies in presentation and disclosure may have resulted in significant misstatements on the FY 1995 Air Force General Fund financial statements.

Summary of Reasons for Disclaimer of Opinion. Material uncertainties existed regarding the reasonableness of amounts reported on the FY 1995 Air Force General Fund financial statements. Amounts reported on the statements, such as property, plant, and equipment of \$234.5 billion, fund balances with Treasury of \$54.7 billion, and operating materials and supplies of \$23.9 billion, were assembled from information systems of uncertain reliability;

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and for most items, auditors were unable to verify the account balances. Because of the unverifiable account balances and the many inadequacies in accounting systems, auditors could not render an opinion on the FY 1995 Air Force General Fund financial statements.

Corrective Actions Taken or Under Way

DoD managers have acknowledged the significant problems that prevent auditors from rendering audit opinions on DoD General Fund financial statements and have taken corrective actions. In response to the financial statement audits and to congressional and public concerns, DoD managers at many levels have initiated actions to address the reported problems. When management corrects the problems, DoD should be able to more effectively control its assets and provide more reliable financial information to senior managers, Congress, and other interested parties. Managers are taking or have completed the following actions to correct problems in financial management.

- o The Army Chief of Staff, in his "State of the Army" message in July 1995, emphasized the need for all Army managers to ensure that the resources entrusted to them are safeguarded closely and used efficiently. The Under Secretary of the Army, in a June 1995 message to Army managers, stressed the importance of ensuring that the Army's management controls are followed. Also, by continuing to emphasize the Army's Joint Reconciliation Program (established by the Army to monitor and improve unmatched disbursements, negative unliquidated obligations, and travel advances), the Assistant Secretary of the Army (Financial Management and Comptroller) has achieved significant progress in reducing unmatched disbursements, negative unliquidated obligations, and outstanding travel advances.

- o The Army's management controls were sufficient to ensure the accurate reporting of wholesale munitions. Inventory transactions processed by the inventory system were accurate, prices in the standard system used to value munitions items were generally accurate, and storage activities reported accurate on-hand balances. In addition, the Army made progress in resolving its control weaknesses in military pay, and the U.S. Army Corps of Engineers improved its controls over construction-in-progress and engineering and design costs; these areas are no longer considered material weaknesses. The Army's Annual Assurance Statements continue to report Army-wide control problems in order to emphasize the corrective actions needed.

- o The DFAS has performed comparative analyses of all property account balances and accrued annual leave balances for the Army National Guard. These analyses disclosed potential reporting errors. In February 1996, the DFAS alerted the National Guard about potential errors in its data on property and annual leave, and about the need for corrective actions. This DFAS action should improve the reliability of data in the Army's future financial statements.

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o Before FY 1995, the Army established the Senior Level Steering Group to oversee actions taken in response to audits conducted for the CFO Act. The Senior Level Steering Group chartered an effort to develop the Stewardship Improvement Plan, which was the Army's plan to better safeguard the Army's resources and facilitate compliance with the CFO Act. Implementation of the Stewardship Improvement Plan is in its formative stages.

o The Secretary of the Air Force established a Financial Improvement Policy Council to coordinate developments between the Air Force and DFAS, particularly in areas where Air Force information systems will interface with DFAS accounting systems.

o The USD(C) established the Acquisition and Financial Management Working Group to resolve the DoD-wide problem of matching disbursements to valid obligations. The working group's report, "Eliminating Unmatched Disbursements, A Combined Approach," was issued in June 1995. That report made 48 recommendations to DFAS and other agencies to correct conditions related to unmatched disbursements and to eliminate existing mismatches, including possible write-offs.

o The DFAS Denver Center, in conjunction with LOGICON Corporation and the accounting firm of KPMG Peat Marwick, is developing concepts for a General Ledger/Funds Control system. The major goals of the General Ledger/Funds Control system are providing double entry, transaction-based general ledgers; converting to the Government standard chart of accounts; using the standard Budget Accounting Classification Code; and providing a general ledger for each appropriation. When completed, this system should enable the Air Force to reduce the total number of financial systems and meet standards set by the General Accounting Office, the Department of the Treasury, the Internal Management Control Program, the CFO Act, and DoD. Appendix E gives details of the key accounting requirements developed by DFAS, and on the requirements of the Budget Accounting Classification Code that new systems must meet.

o The DFAS Denver Center contracted with LOGICON Corporation to review management information systems that have both functional and accounting applications. The purpose of the study was to identify and assess Air Force financial, nonfinancial, and mixed systems that perform finance and accounting functions; identify the resources needed to perform these functions; and evaluate the feasibility of transferring management responsibility from the Air Force to the DFAS Denver Center. For example, as of September 1995, the study had assessed and identified improvements needed to meet requirements of the Internal Management Control Program; training; accounting for property, plant, and equipment; and inventories.

o The DFAS Denver Center is developing the Departmental Cash Management System to satisfy DoD accounting requirements and increase productivity, while reducing costs of the work force and systems needed

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for cash management. The Departmental Cash Management System is being designed to correct material weaknesses, respond to audit findings, and reduce the outstanding balance of undistributed disbursements and negative unliquidated obligations.

- o The DFAS is converting the Air Force civilian pay system to the standard DoD civilian pay system; completion is expected in 1997. DFAS converted the Air Force military pay system to the DoD military pay system in FY 1994 and made several enhancements to the system in FY 1995.

- o The DFAS Denver Center is implementing the Direct Contract Payment Notice System at offices of the Central Procurement Accounting System and has fully implemented the Automated Reconciliation System within the Air Force Materiel Command. The DFAS Denver Center expects that these systems will improve controls over the obligation process, and will reduce the time required to reconcile problem disbursements and discrepancies between Air Force data and the DFAS Columbus Center data. The DFAS Denver Center has also arranged with the Air Force Materiel Command to resolve the command's unmatched disbursements.

- o DoD, DFAS, and the Air Force have initiated several programs that have significantly reduced the cash needed for daily Air Force operations. These initiatives have decreased the disbursing officers' authority to hold cash at active duty and Air Force Reserve locations. DFAS and Air Force financial managers have improved cash management with these initiatives. When levels of cash are reduced, employees have less opportunity to misappropriate this highly vulnerable asset.

- o Officials of the DFAS Denver Center and the Air Force are implementing auditors' previous recommendations to develop a systematic process for compiling and reporting contingent liabilities. Headquarters, DFAS, issued guidance for recording and reporting contingent liabilities in the financial statements, and the Air Force Materiel Command issued a memorandum to instruct field activities in the management of contingent liabilities. In June 1995, the Deputy Assistant Secretary of the Air Force, Financial Operations, requested that the accounting firm of Coopers & Lybrand L.L.P. (Limited Liability Partnership), conduct a baseline assessment of processes used at Air Force Headquarters to collect and report contingent liabilities. The Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) and the DFAS Denver Center changed their reporting of contingent liabilities on financial statements. The Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) established procedures to obtain timely data on contingent liabilities from the Air Force General Counsel. The DFAS Denver Center discontinued its treatment of budgetary contingencies as contingent liabilities, a practice that had caused significant misstatements.

- o DoD managers have established four senior-level groups to reform financial management: the Senior Financial Management Oversight Council, the Financial Management Steering Committee, the Corporate Information

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Management Council, and the Defense Business Operations Fund Corporate Board. These four groups provide guidance and focus to implement financial management reform throughout DoD. The Senior Financial Management Oversight Council meets periodically to address deficiencies in financial management, to approve plans for proactive solutions to those deficiencies, to assign responsibility for correcting deficiencies, and to monitor progress in reforming DoD financial management concepts. The council focuses attention on problem areas and exerts pressure to achieve results. The other three groups meet monthly or as needed. They consist of top financial executives in DoD and members from organizations affected by changes in financial management and are augmented by various inspector general and audit communities.

- o DoD is consolidating and standardizing financial management policy and procedures by condensing more than 70,000 pages of regulations, found in 360 publications, into the 15-volume "DoD Financial Management Regulation," DoD Regulation 7000.14-R. This regulation includes policies and procedures that cover all aspects of managing appropriated and revolving funds.

- o In December 1995, DoD published its annual update to the CFO Financial Management 5-Year Plan. The plan details the objectives and related initiatives for improving operations and systems for DoD financial management. Using this plan, DoD has built its financial management reform program around three main areas: business process reengineering, standardization of systems, and consolidation of operations. Major initiatives are under way simultaneously in all three areas.

- o DoD financial management reform requires that DoD reengineer its business practices. Reengineering involves simplifying, standardizing, and improving regulations and procedures for financial management. As part of the reengineering effort, DoD is studying current procedures in order to standardize and consolidate the many procedures used throughout DoD while identifying and eliminating unneeded or duplicate procedures.

- o While eliminating as many redundant systems as possible, DoD is also moving finance and accounting functions to a select set of standard migratory or interim systems. DoD is integrating its migration systems to meet the requirements of OMB Circular A-127 and to comply with the Internal Management Control Program.

- o DoD plans to reduce 300 accounting and finance sites to 26 to facilitate standardized accounting and finance operations across DoD. In May 1994, the Deputy Secretary of Defense announced the consolidation of DoD finance and accounting functions into the 5 existing regional centers (Cleveland, Columbus, Denver, Indianapolis, and Kansas City) and 21 new operating locations. DoD officials expect that consolidation and financial management reforms will achieve savings by streamlining operations; standardizing procedures, systems, and operations; expanding the use of innovative technology; increasing the work force's productivity; reducing staffing levels; and eliminating unnecessary procedures. In FY 1995, the DFAS Denver Center

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activated 4 operating locations and consolidated 14 base-level accounting operations. The DFAS Denver Center planned to activate another operating location and consolidate an additional 21 base-level operations in FY 1996.

- o DFAS and Air Force managers developed and implemented a joint plan to track the status of management actions taken in response to specific recommendations in CFO audit reports. The plan, which broadly classifies audit recommendations as policy, compliance, or systems and internal control issues, provides DFAS and Air Force managers with consolidated information on progress made toward solving major problems in financial reporting.

- o DFAS and Air Force accounting and financial management systems are not yet integrated under a DoD-wide transaction-driven general ledger. These systems do not meet Comptroller General requirements for timely and accurate preparation of financial statements because they rely on nonfinancial systems for financial information. Therefore, DFAS has initiated a number of interim actions to improve the Air Force's financial reporting until a transaction-driven general ledger is attained. To date, DFAS has selected eight migratory systems. DoD and DFAS have implemented all of these systems except one, which is still in the concept stage.

- o Standardizing data, a major DoD initiative, is critical for implementing data interchange among systems. The goal of this initiative, which DoD began in December 1993, was to reduce the 100,000 Service-unique data elements in more than 250 finance and accounting systems to fewer than 900 standard elements. Thus far, the Services and DFAS have agreed to 540 standard data elements covering all functional areas. DoD has also established a standard DoD chart of accounts for all the Services in order to solve the problems created because each Service has multiple accounting systems that use different data sets. Standardizing the chart of accounts will facilitate both consolidating the Services' financial statements into DoD Consolidated Financial Statements and developing a transaction-driven general ledger.

- o Senior DoD and Air Force officials have made significant progress in addressing chronic problems with unmatched disbursements and negative unliquidated obligations. The improvement resulted from aggressive actions of the USD(C), who directed disbursing officers not to pay any disbursement over \$5 million until they had validated the proposed payment with corresponding obligation data. The USD(C) subsequently lowered the \$5 million criterion to \$1 million at most organizations.

- o Renewed efforts by DoD, Air Force, and DFAS personnel reduced the number of Antideficiency Act violations from 87 in FY 1992 to 6 in FY 1995. This occurred because the Air Force emphasized the correction and advance detection of Antideficiency Act violations.

- o The DFAS Denver Center has two initiatives to detect fraudulent or erroneous payment. First, the Center participates in "Operation Mongoose," a DoD operation to identify fraud through computer matching of automated files. Second, the Center has strengthened internal controls to improve the accuracy and validity of vendor payments.

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- o At Headquarters, DFAS, an Electronic Commerce Program Management Office was established in March 1995 to promote the use of electronic data interchange and electronic funds transfer. These business practices collect data in electronic form at its source and use that data throughout the payment process, including interfaces with disbursing and accounting systems. DFAS plans to implement electronic data interchange and electronic funds transfer for vendor payments.

- o The Assistant Secretary of the Air Force (Financial Management and Comptroller) has consolidated financial management in a new directorate whose main tasks are to improve business procedures, foster compliance with laws, respond to audit findings, and support the transition to modern automated financial systems. The directorate promotes long-range improvements to financial information systems by defining requirements and promoting a modern automated financial system.

The actions taken by the various levels of DoD management have improved the data reported in the DoD General Fund financial statements. However, DoD must strive for continued improvement in its financial data, which have been adversely impacted by financial management deficiencies and an inadequate internal control structure. Despite these obstacles, the AAA, with cooperation from Army leadership, plans to conduct audits regardless of the deficient accounting systems, and will attempt to render an audit opinion other than a disclaimer on future Statements of Financial Position for the Army General Fund. This effort will require substantial resources from both management and auditors.

Auditors' Proposed Adjustments to Financial Statements. Auditors identified \$23.3 billion of required adjustments to amounts reported in the FY 1995 Army General Fund financial statements, and \$6.3 billion of required adjustments to amounts reported in the FY 1995 Air Force General Fund financial statements and footnotes. During the audits of the FY 1994 General Fund financial statements, auditors identified over \$19.2 billion and \$90.9 billion of required adjustments for the Army and the Air Force financial statements, respectively.

DFAS Progress Toward Adequate General Fund Accounting Systems. Although hampered by various difficulties, the most significant of which is the lack of adequate accounting systems, DFAS has begun several actions that will assist in solving the financial management problems reported by the auditors. The following are two examples of recent actions taken by DFAS to improve financial data; these actions will eventually enable auditors to render opinions other than disclaimers on DoD General Fund financial statements.

- o On May 28, 1996, the USD(C) directed the DFAS to proceed with development of the Corps of Engineers Financial Management System as the General Fund migratory accounting system for the DFAS Indianapolis Center customers. (The Army is that Center's main customer.)

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o On July 25, 1996, the USD(C) directed DFAS to proceed with the development of the Corps of Engineers Financial Management System as the General Fund migratory accounting system for DFAS Denver Center customers. (The Air Force is that Center's main customer.)

The DFAS has recognized that the lack of adequate accounting systems is a major obstacle preventing auditors from rendering opinions other than disclaimers on the DoD General Fund financial statements. Until these recent actions, DoD had made minimal progress in correcting accounting system deficiencies in order to comply with the key accounting requirements (see Appendix E for details of the key accounting requirements). See Appendix F for further details of DoD efforts to improve General Fund accounting.

Federal Accounting Standards Advisory Board (FASAB) Accounting Standards. In addition to the corrective actions discussed above, the FASAB has published several accounting standards and concepts that will affect the preparation and auditing of General Fund financial statements in FY 1997 and beyond. In the past, DoD has used the lack of Federal guidance as a basis for not adopting policies and procedures recommended by the auditors. For example, the Army and DFAS were unable to report probable contingent liabilities properly. The auditors recommended that these liabilities be reported in the financial statements in order to comply with generally accepted accounting standards. However, the Army and DFAS could not report the probable contingent liabilities in the financial statements because DoD policy prevented them from doing so. Implementation by DoD of the OMB Statement of Federal Financial Accounting Standard (SFFAS) No. 5, "Accounting for Liabilities of the Federal Government," may remove this major deficiency, which has prevented auditors from rendering an opinion. When OMB SFFAS No. 8, "Supplementary Stewardship Reporting," is implemented, many asset reporting deficiencies that prevent auditors from rendering audit opinions may no longer exist. This may occur because a significant amount of property, plant, and equipment will be removed from the Statement of Financial Position and reported on a stewardship report. See the following table for a list of the accounting standards and concepts.

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Status of FASAB Statements			
<u>Number</u>	<u>Title</u>	<u>Status</u>	<u>Date</u>
Standard No. 1	Accounting for Selected Assets and Liabilities	Final ¹	March 30, 1993
Standard No. 2	Accounting for Direct Loans and Loan Guarantees	Final	August 23, 1993
Standard No. 3	Accounting for Inventory and Related Property	Final	October 27, 1993
Standard No. 4	Managerial Cost Accounting Standards for the Federal Government	Final	July 31, 1995
Standard No. 5	Accounting for Liabilities of the Federal Government	Final	September 1995
Standard No. 6	Accounting for Property, Plant, and Equipment	Final	June 1996
Standard No. 7	Accounting for Revenue and Other Financing Sources	Final	May 10, 1996
Standard No. 8	Supplementary Stewardship Reporting	Recommended ²	June 26, 1996
Concept No. 1	Objectives of Federal Financial Reporting	Final	September 2, 1993
Concept No. 2	Entity and Display	Final	June 6, 1995

¹Final: Issued for implementation by prescribed date.
²Recommended: Approved by all Principals of the Joint Financial Management Improvement Program and undergoing Congressional review.

The FASAB is currently evaluating natural resources, capital costs, and the management discussion and analysis section of the financial statements. FASAB will also explore producing a guide that will answer common questions about FASAB standards and an expense-expenditure guide to aid accountants and budget analysts in understanding the flow of costs and recognition of expenditures. Finally, FASAB is planning to codify all FASAB concepts and standards in one volume.

Summary of Corrective Actions. DoD managers have acknowledged significant problems with financial data and have taken various actions to improve the data used to compile the DoD General Fund financial statements. The Army and DFAS have made progress in resolving military pay control weaknesses and in reducing unmatched disbursements, negative unliquidated obligations, and outstanding travel advances. The Air Force and DFAS have begun to coordinate systems, improve controls over the obligation process, reduce the time required to reconcile problem disbursements, and increase the accuracy of Air Force payroll data. DoD, including DFAS, is undertaking numerous actions to improve financial management of the DoD General Fund.

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DoD implementation of the FASAB standards may speed the elimination of some major deficiencies that prevent auditors from rendering audit opinions on DoD General Fund financial statements.

However, progress in correcting accounting system deficiencies to comply with the 13 key accounting requirements is slow and the latest estimate for fielding adequate systems is not before FY 2002. DFAS continues its attempts to develop adequate accounting systems for the DoD General Funds by evaluating its options and solutions for a General Fund accounting system. Noteworthy progress was made when the USD(C) designated the Corps of Engineers Financial Management System as the migratory accounting system for both Army and Air Force General Fund accounting. Until DFAS definitizes and begins to execute its design and deployment plans for the Corps of Engineers Financial Management System, we cannot estimate when auditable General Fund financial statements can be prepared using accounting system data. Therefore, disclaimers of opinion can most likely be expected into the next century for the Army, Navy, and Air Force General Fund Statements of Financial Position and Statements of Operations, as well as the DoD Consolidated Financial Statements. Despite these obstacles, the AAA, with cooperation from Army leadership, is developing plans to conduct a review of the assets and liabilities of the Army General Fund by reviewing data available from systems other than the DFAS deficient accounting systems, and will attempt to render an audit opinion other than a disclaimer on future Statements of Financial Position for the Army General Fund. This effort is commendable, but it will require a massive commitment of resources from both management and auditors, which may be impractical and cost prohibitive.

Conclusion

Until DoD implements the corrective actions needed to overcome these deficiencies, auditors will continue to have problems in rendering audit opinions on the DoD general fund financial statements. When auditing the FY 1996 Navy and Defense agencies' General Fund financial statements, auditors expect to find problems similar to those found while auditing the Army and Air Force General Fund financial statements during the past 8 years. Implementation and enforcement of good policies and procedures, including the FASAB standards, can substantially improve the accuracy of DoD financial statements until adequate accounting systems are in place for the preparation of General Fund financial statements. To move toward auditable financial statements, the Navy must take many of the same actions as the Army and the Air Force.

As discussed previously, DFAS has made progress in selecting a DoD General Fund accounting system. However, this accounting system should not be viewed as the solution to all DoD accounting problems. The development of this accounting system notwithstanding, DoD must continue to strive for near-term improvements in internal controls. These benefits include producing more accurate and reliable financial information. DoD financial managers need accurate and reliable information to make informed decisions and to properly

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manage DoD programs. DoD also needs to focus attention on establishing a sound internal control structure with an adequate control environment, reliable accounting systems, and sufficient control procedures. Audits are needed to assess management's efforts to correct deficiencies and to ensure that DoD financial managers continue to work toward producing accurate and reliable financial information that is the basis for auditable DoD General Fund financial statements. Auditors will continue to identify and report deficiencies and provide advice and assistance as work continues on improving the DoD General Fund financial statements.

Management Comments on the Finding and Audit Response to the Comments

The USD(C) took exception to three conclusions presented in the draft report. He took exception to the conclusion that disclaimers of opinion can be expected well into the next century and that the DoD basis of accounting and accounting policy for contingent liabilities prevented the AAA from rendering an audit opinion on the Army General Fund financial statements. See Part III for the complete text of management comments.

Management Comments on Time Frames for Audit Opinion. The USD(C) disagreed with our conclusion that disclaimers of opinion can be expected well into the next century for Army, Navy, and Air Force General Fund financial statements, as well as for the DoD Consolidated Financial Statements. The USD(C) stated that DoD, in its Chief Financial Officer Financial Management 5-Year Plan, October 1995, concluded ". . . that *full* compliance with the Chief Financial Officers Act cannot be expected in the near term." The USD(C) stated, "However, stretching 'near term' into 'well into the next century' does not appear to be adequately supported by findings in the audit report."

Audit Response. We have reconsidered the appropriateness of the phrase "well into the next century." Since the USD(C) agreed that opinions other than disclaimers of opinion cannot be expected in the near term, we have changed "well into the next century" to "most likely be expected until the next century."

Management Comments on the Basis of Accounting. The USD(C) disagreed with the conclusions concerning the basis of accounting. The USD(C) believes its policies are consistent with the hierarchy of accounting standards issued by OMB. Although the AAA audit opinion concluded that the USD(C) has established an accounting hierarchy different from that promulgated by the OMB, specific evidence was not provided to support that conclusion. The USD(C) believes that our audit report should be rewritten to delete any reference to USD(C) establishing an accounting hierarchy different from that promulgated by OMB. Alternatively, if we can provide specific evidence to support the conclusion, such evidence should be explicitly presented, and the USD(C) should be given an opportunity to address the evidence.

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Audit Response. The USD(C) basis of accounting is not consistent with the hierarchy of accounting principles and standards issued by the OMB; we have specific evidence to support this conclusion. Furthermore, if the USD(C) continues to use a basis of accounting which deviates from the hierarchy, it will be very difficult for DoD to attain a qualified or unqualified opinion on the Military Departments' General Fund financial statements or on the DoD Consolidated Financial Statements. The "DoD Guidance on Form and Content of Financial Statements for FY 1994 and FY 1995 Financial Activity" ("DoD Form and Content"), October 20, 1994, should be based on OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements" ("OMB Form and Content"), November 29, 1993. However, the "DoD Form and Content" conflicts with the "OMB Form and Content" in many areas.

By requiring DoD Components to use the "DoD Form and Content," the USD(C) has established a different basis of accounting hierarchy from that promulgated by OMB, and improperly placed the "DoD Form and Content" at the top of the hierarchy. To illustrate the DoD Components' adherence to the alternative basis of accounting hierarchy required by the USD(C), in the "Department of the Army, Annual Financial Report, Fiscal Year 1995" (Note 1.A., page 50), the Army stated that the "DoD Form and Content" is at the top of the hierarchy of accounting principles and standards used to prepare the FY 1995 Army financial statements, followed by the "OMB Form and Content." By placing the "DoD Form and Content" at the top of the hierarchy of accounting principles and standards, the USD(C) is contradicting the "OMB Form and Content" which recognized prevalent agency accounting policy only after first considering standards published by the Joint Financial Management Improvement Program Principals and "OMB Form and Content" requirements included in OMB Bulletin No. 93-02, "OMB Form and Content (superseded by OMB Bulletin No. 94-01)," and subsequent issuances.

In addition, the "DoD Form and Content" and other agency-specific policies are not recognized as a basis for accounting with the implementation of OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. OMB Bulletin No. 97-01, which must be fully implemented in FY 1998, omits "accounting standards contained in agency accounting policy, procedures, manuals, and/or related guidance. . ." from its hierarchy. As a result, guidance in the "DoD Form and Content" and other DoD-specific sources are omitted from the hierarchy. The following are three examples of conflicts between the "DoD Form and Content" and the "OMB Form and Content."

Contingent Liabilities. The USD(C) statement "The Department's policy for recording contingent liabilities mirrors the requirements contained in OMB Bulletin 94-01 ("OMB Form and Content")" is incorrect. The "DoD Form and Content" does not address contingent liabilities for environmental cleanup costs, the USD(C) prevented the Army and DFAS from recording the \$14.6 billion of contingent liabilities for cleanup cost in FY 1995 that are both probable and reasonably estimable. The "OMB Form and Content" (Note 27, page 84), has always required recording of contingent liabilities in accordance with the American Institute of Certified Public Accountants (AICPA) Statement of Financial Accounting Standards (SFAS) No. 5, "Accounting for

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Contingencies." AICPA SFAS No. 5 requires that a contingent liability must be recorded on the financial statements if it is probable that the liability will develop into an actual loss and the amount of the loss can be reasonably estimated. In FY 1995, the Army identified \$14.6 billion of cleanup costs associated with hazardous waste removals that should be recorded in the financial statements as contingent liabilities.

War Reserves. The "DoD Form and Content" requires presenting war reserves on the Stockpile Materials line on the financial statements (Appendix 3-B, page 3-20, paragraph 1.g.) which contradicts both the "OMB Form and Content" (page 18, paragraph 1.f.) and OMB SFFAS No. 3, "Accounting for Inventory and Related Property," October 27, 1993 (page 13, paragraph 51). The "OMB Form and Content" did not specifically address the presentation of war reserves on the financial statements. However, the "OMB Form and Content" defined stockpile materials (page 18, paragraph 1.f.) as ". . . strategic and critical materials held due to statutory requirements for use in national defense, conservation or national emergencies. They are not held with the intent of selling in the ordinary course of business." OMB SFFAS No. 3 also did not specifically address the presentation of war reserves on the financial statements, but used the same definition as the "OMB Form and Content" for stockpile materials. Although both the "OMB Form and Content" and OMB SFFAS No. 3 did not specifically address the presentation of war reserves on the financial statements, their definition of stockpile materials, where DoD presents war reserves, did not include war reserves. Also, representatives from OMB and FASAB have confirmed that war reserves should not be presented as stockpile materials.

Fund Balance With Treasury. The "DoD Form and Content" requires presenting three subordinate line items (Funds Collected, Funds Disbursed, and Funds With Treasury) for Fund Balance With Treasury on the Statement of Financial Position (balance sheet); the "OMB Form and Content" does not have the same requirement. For the FY 1995 Army General Fund, DFAS was forced to report \$167.7 billion of income statement data on the balance sheet. The balance sheet discloses the assets, liabilities, reserves, and equities of an entity at a specified date, properly classified to exhibit the financial position of the entity at that date. The subordinate line items required by DoD reflect activity over a period of 12 months; therefore, these items conflict with the purpose of a balance sheet, which is to reflect the status of assets at a specific point in time. The inclusion of these subordinate line items on the balance sheet is inappropriate, since the items address activity that is more appropriately reflected on the Statement of Operations (income statement). Including billions of dollars of income statement activity on the balance sheet is misleading to users of the financial statements.

We continue to believe that the USD(C) requires the Army and DFAS to prepare the Army General Fund financial statements according to a hierarchy that begins with the "DoD Form and Content" rather than the hierarchy prescribed in the "OMB Form and Content." With the changes to the hierarchy in OMB Bulletin No. 97-01, the USD(C) must move away from DoD-specific policies that conflict with OMB policy and comply with Federal Government generally accepted accounting principles as provided in the hierarchy.

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Management Comments on Contingent Liabilities. The USD(C) states that DoD policy for recording contingent liabilities mirrors the requirements of the "OMB Form and Content." The USD(C) also states, "The allegation that the policies promulgated by this office prevents the Army from complying with OMB guidance is from an old audit report. The allegation was not true then; and it is not true now." On June 23, 1994, the USD(C) responded to AAA Report No. HQ 94-450, "Audit of the Army's FY 93 Financial Statements, Audit Opinion," June 30, 1994, advising AAA that the cleanup costs causing a disclaimer were potential claims against future budgetary resources, not contingent liabilities as defined in the OMB guidance. The June 23, 1994, response also stated that when new Government-wide standards were adopted and promulgated, DoD would implement those standards. The FASAB only recently recommended accounting standards for contingent liabilities. These standards were issued by OMB in the OMB SFFAS No. 5. Even more recently, the OMB issued the OMB SFFAS No. 6, "Accounting for Property, Plant and Equipment." Until the recent publication of FASAB standards and the acceptance of those standards by OMB, no Government-wide standards existed, and the DoD standards were acceptable. Consistent with OMB policy, DoD will continue to consider cleanup costs as potential claims against future budgetary resources through FY 1997.

Beginning with FY 1998, DoD will implement OMB SFFAS No. 6 as required by OMB. The USD(C) also stated that the FASAB determined that the recording of contingent liabilities depended not only on liabilities being probable and measurable, but also on whether the contingencies were a Government-related event or a Government-acknowledged event. The FASAB determined that another class of contingent liabilities existed for which additional guidelines must be established. The additional class of liabilities is cleanup costs associated with property, plant, and equipment. It is these latter costs that the AAA adamantly has maintained that the Department should recognize as contingent liabilities. However, consistent with OMB guidance, those costs are potential claims on future resources--not contingent liabilities. The OMB SFFAS No. 6 acknowledges that this class of contingent liabilities exists for which liabilities and expenses are recorded differently based upon whether cleanup costs are the result of the Government's use of general property, plant and equipment or Federal mission assets.

Audit Response. DoD policy for recording contingent liabilities does not mirror the requirements contained in OMB policy. Both existing law and OMB SFFAS No. 5 require recognition and reporting of liabilities--including environmental cleanup costs for past events--on the DoD Statement of Financial Position. Reporting requirements for environmental cleanup cost liabilities from long-term (future) Federal operations associated with the day-to-day use of property, plant and equipment will be further defined with full implementation of OMB SFFAS No. 6 in FY 1998.

The USD(C) maintains the position that the cleanup costs causing a disclaimer ". . . were not contingent liabilities in the sense of OMB Bulletin 94-01 ("OMB Form and Content") but, instead, were potential claims against future budgetary resources." The USD(C) claimed that this policy was consistent with OMB guidance. However, the USD(C) did not give the citation from the "OMB

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Form and Content" that was used to make this determination. Our review of the "OMB Form and Content" did not locate any such citation. Furthermore, the only support the USD(C) provided for this position was its June 23, 1994, response to AAA Report No. HQ 94-450, in which the USD(C) advised AAA that cleanup costs were potential claims against future budgetary resources because: (1) the claims for the costs were in doubt, (2) the costs were only a rough estimate, (3) the impact of future technology on costs was uncertain, and (4) the claims were not in the budget. This argument for classifying cleanup costs as potential claims against future budgetary resources, not contingent liabilities, is inconsistent with current policy. Existing law requires DoD to clean up hazardous materials at current and former installations. To meet these requirements, the Army has identified sites requiring cleanup and has estimated the cleanup costs for the sites. Therefore, the requirements for recognizing the liability--probable and reasonably estimable--have clearly been met and the liabilities should be reported on the Statement of Financial Position, regardless of whether they are covered by available budgetary resources. These cleanup costs do not fit the USD(C) definition of potential claims against future budgetary resources because they are not in doubt, rough to estimate, and uncertain as to the impact of future technology. Furthermore, whether or not a cleanup cost is a claim on future budgetary resources does not affect the existence of a reportable liability. To the contrary, OMB SFFAS No. 6 (page 53, paragraph 195) states that not recognizing cleanup costs until they are budgeted for ". . . is not only inconsistent with the definition of a liability but would keep users of the financial statements in the dark as to the magnitude of Federal commitments for environmental cleanup."

The USD(C) also reiterated a statement from the June 23, 1994, response that, until the recent publication of FASAB standards, and the acceptance of those standards by OMB, there were no Government-wide standards in the contingent liabilities area to be followed, and the DoD standards were acceptable. The USD(C) added that once new Government-wide standards were adopted and promulgated, DoD would implement those standards. We disagree with the USD(C) statement that there were no Government-wide standards in the contingent liabilities area, and we also disagree with the statement that the current DoD standards are acceptable. Contingent liability standards have been in force since the FY 1994 "OMB Form and Content" was published in November 1993, and DoD standards conflict with this Government-wide guidance. The "OMB Form and Content" (Note 27, page 84) requires disclosure of ". . . information for both loss or gain contingencies as required by (AICPA) Statement of Financial Accounting Standards No. 5, 'Accounting for Contingencies.'" Therefore, policy for recognizing contingent liabilities has been in force since 1993 when the "OMB Form and Content" adopted the requirements of AICPA SFAS No. 5. AICPA SFAS No. 5, paragraph 8, states the following.

Major Deficiencies Preventing Auditors From Rendering Audit Opinions on FY 1995 DoD General Fund Financial Statements

An estimated loss from a loss contingency . . . shall be accrued by a charge to income if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been accrued at the date of the financial statements. . .

b. The amount of the loss can be reasonably estimated.

Consequently, the USD(C) is incorrect in the argument that, until the recent OMB issuance of OMB SFFAS No. 5, "Accounting for Liabilities of the Federal Government," September 1995, there were no Government-wide standards on contingent liabilities. OMB SFFAS No. 5 only endorsed existing OMB policy and contained the same requirements referenced in the November 1993 "OMB Form and Content." OMB SFFAS No. 5 (page 12, paragraph 38), states the following.

A contingent liability should be recognized when all these three conditions are met:

- o A past event or exchange transactions has occurred . . .
- o A future outflow or other sacrifice or resources is probable . . .
- o The future outflow or sacrifice of resources is measurable . . .

The USD(C) also incorrectly claimed that the AAA position is for DoD to recognize an additional class of contingent liabilities identified in OMB SFFAS No. 6, "Accounting for Property, Plant, and Equipment," June 1996. OMB SFFAS No. 6 only addresses accounting for environmental cleanup cost liabilities from long-term (future) Federal operations associated with the day-to-day use of property, plant, and equipment--not environmental cleanup cost liabilities for past events which are addressed by OMB SFFAS No. 5. In the following excerpt from OMB SFFAS No. 6 (Executive Summary, page viii), it is clear that OMB SFFAS No. 6 only relates to the recognition of cleanup costs over the life of property, plant, and equipment.

The Board has completed recommended accounting standards for liabilities which address liabilities for environmental cleanup resulting from an accident, natural disaster, or other one-time occurrence [past event]. Those liability standards [OMB SFFAS No. 5] do not address inter-period cost allocation when cleanup relates to operations that span many periods [future events]. Therefore, the Board chose to provide additional guidance relative to cleanup costs in this standard. The additional standards in this statement provide for the timing of recognition of the liability and related operating expense.

It is the environmental cleanup cost liabilities for past events that AAA adamantly has maintained that DoD should recognize as contingent liabilities--not cleanup cost liabilities from long-term operations of property, plant, and equipment. Aside from addressing this additional class of contingent liabilities,

Major Deficiencies Preventing Auditors From Rendering Audit Opinions on FY 1995 DoD General Fund Financial Statements

OMB SFFAS No. 6 did not alter existing policy on recognizing contingent liabilities. As stated in OMB SFFAS No. 6 (Appendix A, page 51, paragraph 183), "The guidance in this standard builds on the accounting standards developed for liabilities." In addition, OMB SFFAS No. 6 (Appendix A, page 51, paragraph 184) states, "The liabilities standard (which refers to OMB SFFAS No. 5) is applicable to cleanup costs."

The USD(C) stated that the recording of contingent liabilities depended not only on liabilities being probable and measurable, but also on whether the contingencies resulted from a Government-related event or a Government-acknowledged event. OMB SFFAS No. 5 clearly illustrates that environmental cleanup costs are liabilities resulting from Government-related events; the liabilities should be recognized in the period the damage occurred. OMB SFFAS No. 5 (page 8, paragraph 28) states:

Government-related events include:

(1) cleanup from federal operations resulting in hazardous waste that the federal government is required by statutes and/or regulations, that are in effect as of the Balance Sheet date, to clean up (i.e., remove, contain, or dispose of);

(2) accidental damage to nonfederal property caused by federal operations; and

(3) other damage to federal property caused by such factors as federal operations or natural forces.

Therefore, according to OMB SFFAS No. 5, environmental cleanup results from Government-related events and the subsequent cleanup costs should be recognized as liabilities on agency financial statements.

Finally, the USD(C) is correct to contend that the conclusion concerning DoD policy preventing the Army from complying with "OMB Form and Content" is from an old audit report. However, the USD(C) failed to note that this issue was also reported in AAA FY 1994 and FY 1995 opinion reports as one of the disclaimer reasons. In AAA Report No. 96-152, "Examination of the Army's Financial Statements for Fiscal Years 1995 and 1994," March 15, 1996, page 9, AAA stated that "DoD policy prevents the Army from following OMB reporting requirements for probable contingent liabilities." Consequently, the Army had contingent liabilities of \$25 billion in FY 1994 and \$14.6 billion in FY 1995 which were not recorded as liabilities on its Statement of Financial Position.

Part II - Additional Information

Appendix A. Scope and Methodology

Audit Work Performed. Because the Navy and Defense agencies had made limited progress toward issuing FY 1995 General Fund financial statements, we reviewed only Army and Air Force Audit Agency reports on the FY 1995 Army and Air Force General Fund financial statements. See Appendix C for a list of the FY 1995 audit reports we reviewed. Audit reports were not issued for the Navy and the Defense agencies because the Navy and Defense agencies are not required to submit financial statements for audit until FY 1996. The audit was limited to identifying and summarizing the major deficiencies that prevented auditors from rendering audit opinions on the FY 1995 DoD General Fund financial statements. We defined "major deficiency" as a reason that auditors could not render an audit opinion, as reported in their FY 1995 audit reports. The audit was further limited to identifying the actions taken or under way to correct or remove these deficiencies. We defined "corrective actions taken or under way" to remove the major deficiencies as those reported by the AAA and the Air Force Audit Agency in their FY 1995 audit reports.

Audit Period, Standards, and Locations. We performed this program audit during the period November 1995 through May 1996. The audit was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD. We did not use computer-processed data or statistical sampling procedures to conduct this audit. Appendix G lists the organizations we visited or contacted.

Appendix B. Prior Audits and Other Reviews

Prior Audits. IG, DoD, Report No. 95-301, "Major Deficiencies Preventing Auditors From Rendering Audit Opinions on DoD General Fund Financial Statements," August 29, 1995, summarized the major deficiencies that prevented auditors from rendering audit opinions on Army and Air Force FY 1993 and 1994 General Fund financial statements. The report identified four major deficiencies.

- o Adequate accounting systems were not in place.
- o Assets were not reported adequately or properly valued.
- o Account balances for disbursements and collections were questionable.
- o Contingent liabilities were not recognized or adequately disclosed.

The report also discussed corrective actions taken or under way. The report did not contain any recommendations for corrective action.

Other Reviews. The USD(C) reviewed audit reports on DoD FY 1995 financial statements and transmitted the "Report on Audited Financial Statements, Fiscal Year 1995," to OMB on May 6, 1996. The USD(C) has issued the "Report on Audited Financial Statements" for the last 5 years. Each year, the report has contained conclusions similar to those in this year's report. The "Report on Audited Financial Statements, Fiscal Year 1995" summarized the critical information in the audit reports. Critical information included the impediments to auditable financial statements and deficiencies identified by auditors. The impediments included deficiencies in accounting systems, internal controls, and compliance. A summary of the impediments and corrective actions identified in the report follows.

Impediments to Auditable Financial Statements. The USD(C) concluded that DoD financial management systems did not generate auditable financial statements. DoD managers identified numerous problems with financial systems. The significant problems included the following.

- o **Lack of Transaction-Driven General Ledgers.** Finance and accounting systems lacked a single, standard transaction-driven general ledger, which is essential for reliable financial reports.
- o **Nonintegrated Databases.** Nonintegrated databases prevented the easy or reliable integration or interfacing of information from nonfinancial functional areas (such as personnel, acquisition, and logistics) with finance and accounting systems.

Appendix B. Prior Audits and Other Reviews

o **Inflexible Finance and Accounting Systems.** Finance and accounting systems often were not sufficiently flexible to rapidly respond to changing customer bases, new legislation, contingency operations, management initiatives, requirements from other Government agencies, and other changes.

o **Lack of Automated Indicators.** Finance and accounting systems often did not include automated indicators that measured or were linked to costs, performance measurements, or other output measurements.

All of those weaknesses contributed to unreliable financial data. The weaknesses included the failure to verify and reconcile cash; incorrect valuation and reconciliation of inventories; inaccurate reporting of property, plant, and equipment; and failure to report financial data consistently and promptly. Specific weaknesses were cited as examples of inadequate internal controls and undocumented audit trails. The USD(C) concluded that these impediments to auditable financial statements were due largely to long-standing systems problems, and that the systems problems will require a number of years to correct.

Corrective Actions Planned by DoD. The USD(C) stated that DoD efforts to achieve audited financial statements focus on two major areas: automated systems and standardized policies and procedures.

The diversity and complexity of DoD business affairs increase the challenge of bringing DoD into full compliance with the CFO Act. The ability of DoD to achieve auditable financial statements depends on the application of adequate resources to solve existing problems. Modifying DoD financial management systems and processes will be costly. The planned changes will make the systems more efficient, resulting in less costly financial system operations. However, additional functions will be required, and the increased cost of those added functions will partially offset expected savings. Once the needed improvements are completed, DoD financial operations should provide much more accurate, timely, and useful financial information.

To aid in achieving these objectives, DoD established a Senior Financial Management Oversight Council chaired by the Deputy Secretary of Defense. In addition, the Deputy Secretary established the Defense Business Operations Fund (DBOF) Corporate Board to oversee actions and milestones for the improvement of DBOF. The Board monitors DBOF implementation and operation (including policies, rates, criteria, and analysis for cash flow) and schedules regular reviews of business area performance. The USD(C) also chairs a DoD Financial Management Steering Committee. This committee oversees the development of functional requirements, facilitates the implementation of policy recommendations, and addresses financial management systems and practices for accounts and funds other than those involving the DBOF.

When DoD standardizes and reduces the number of its financial management systems, the benefits will be significant. The maintenance cost of some 250 systems will be reduced to the costs of a few enhanced, standardized systems. The quality and timeliness of financial information should be greatly enhanced,

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giving managers more relevant data to use in managing DoD business affairs and resolving complex problems and issues. DoD will receive additional benefits from the use of electronic funds transfers and electronic data interchange. These capabilities will allow the electronic transfer of most of the data needed to send invoices to vendors, make contract payments, settle travel vouchers, and make direct deposits of military and civilian pay.

The financial management plans of DoD continue to focus on automated systems, standardized policies and procedures, and compliance. All DoD Components are integral to the execution of these plans. Senior DoD management must participate by defining financial management standards, selecting appropriate financial systems, and enforcing a standard financial management policy in all DoD Components.

In summary, DoD places a high priority on correcting deficiencies in its financial systems and is devoting top-level attention to correcting those deficiencies. However, because of the extent of the deficiencies and the scope of the challenge that DoD faces to achieve audited financial statements, DoD cannot fully comply with the CFO Act in the near future. Considerable time, money, and effort will be required to achieve auditable financial statements.

Appendix C. Audit Reports Issued for the FYs 1993, 1994, and 1995 General Fund Financial Statements

IG, DoD, Reports

Army FY 1993 General Fund Financial Statements

Defense Finance and Accounting Service Work on the Army FY 1993 Financial Statements (Report No. 94-168), July 6, 1994.

Air Force FY 1993 General Fund Financial Statements

Defense Finance and Accounting Service Work on the Air Force FY 1993 Financial Statements (Report No. 95-067), December 30, 1994.

Air Force FY 1994 General Fund Financial Statements

Defense Finance and Accounting Service Work on the Air Force FY 1994 Financial Statements (Report No. 95-264), June 29, 1995.

Army FY 1995 General Fund Financial Statements

Compilation of FY 1995 and FY 1996 DoD Financial Statements at the Defense Finance and Accounting Service, Indianapolis Center (Report No. 96-161), June 13, 1996.

Army Audit Agency Reports

Army FY 1993 General Fund Financial Statements

Audit of the Army's FY 93 Financial Statements, Audit Opinion (Report No. HQ 94-450), June 30, 1994.

Audit of the Army's FY 93 Financial Statements, DoD Policy Issues (Report No. HQ 94-451), August 31, 1994.

Audit of the Army's FY 93 Financial Statements, Followup Issues (Report No. HQ 94-452), August 30, 1994.

**Appendix C. Audit Reports Issued for the FYs 1993, 1994, and 1995
General Fund Financial Statements**

Audit of the Army's FY 93 Financial Statements, Retail Military Equipment (Report No. WR 94-473), August 31, 1994.

FY 93 Financial Statements, Civil Works, U.S. Army Corps of Engineers (Report No. SR 94-481), June 30, 1994.

Audit of the Army's FY 93 Financial Statements, Cash Flow Statement (Report No. SR 94-485), August 31, 1994.

Financial Reporting of Conventional Ammunition (Report No. NR 94-446), August 4, 1994.

Audit of the Army's FY 93 Financial Statements, Military and Civilian Payrolls (Report No. SR 94-486), August 30, 1994.

Army FY 1994 General Fund Financial Statements

Audit of the Army's Principal Financial Statements, Fiscal Years 1994 and 1993, Audit Opinion (Report No. HQ 95-451), March 23, 1995.

Audit of General Ledger Accounting, Standard Operation and Maintenance, Army Research and Development System (Report No. SR 95-452), June 8, 1995.

Audit of Financial Operations, U.S. Army Materiel Command (Report No. SR 95-451), September 27, 1995.

Audit of the Army's FY 94 Financial Statements, Military Travel and Pay Advances (Report No. NR 95-7), June 20, 1995.

Audit of the Army's FY 94 Financial Statements, Financial Reporting of Wholesale Assets (Report No. NR 95-428), June 19, 1995.

Army FY 1995 General Fund Financial Statements

Examination of the Army's Financial Statements for Fiscal Years 1995 and 1994, Auditor's Report (Report No. AA 96-152), March 15, 1996.

Examination of the Army's Financial Statements for Fiscal Years 1995 and 1994, Report on Internal Controls and Compliance With Laws and Regulations (Report No. AA 96-154), July 11, 1996.

Financial Reporting of Wholesale Munitions, U.S. Army Industrial Operations Command, U.S. Army Missile Command (Report No. AA 96-155), April 19, 1996.

Financial Reporting of Equipment In Transit (Report No. AA 96-156), June 17, 1996.

Financial Reporting of Wholesale Equipment (Draft Report No. AA 96-160), 1996.

Appendix C. Audit Reports Issued for the FYs 1993, 1994, and 1995 General Fund Financial Statements

Travel Advances, Defense Accounting Office, U.S. Army Missile Command (Report No. AA 96-157), May 20, 1996.

Standard Operations and Maintenance Army Research and Development System and Subsidiary Ledgers, Defense Accounting Office, U.S. Army Missile Command (Report No. AA 96-158), June 3, 1996.

Wholesale Equipment, Tobyhanna Defense Distribution Depot (Report No. AA 96-159), June 18, 1996.

Corps of Engineers, Civil Works Program, FY 1994 General Fund Financial Statements

Audit of FY 94 Financial Statements, Civil Works, U.S. Army Corps of Engineers (Report No. SR 95-449), March 13, 1995.

Corps of Engineers, Civil Works Program, FY 1995 General Fund Financial Statements

Audit of the Conditions Found in Previous Financial Statement Audits, Civil Works, U.S. Army Corps of Engineers (Report No. AA 96-137), February 26, 1996.

Air Force Audit Agency Reports

Air Force FY 1993 General Fund Financial Statements

Opinion on FY 1993 Air Force Consolidated Financial Statements (Report No. 94053022), June 30, 1994.

Review of Military Equipment, FY 1993 Air Force Consolidated Financial Statements (Report No. 93053024), July 20, 1994.

Review of Inventories Not Held For Sale, FY 1993 Air Force Consolidated Financial Statements (Report No. 94053031), July 1, 1994.

Review of Equipment and Vehicle Inventory, FY 1993 Air Force Consolidated Financial Statements (Report No. 93053007), July 22, 1994.

Review of Contingent Liabilities, FY 1993 Air Force Consolidated Financial Statements (Report No. 94053024), August 8, 1994.

Review of Real Property, FY 1993 Air Force Consolidated Financial Statements (Report No. 94053026), July 27, 1994.

Review of Accuracy and Validity of Air Force Obligations, FY 1993 Air Force Consolidated Financial Statements (Report No. 93053015), August 26, 1994.

**Appendix C. Audit Reports Issued for the FYs 1993, 1994, and 1995
General Fund Financial Statements**

Review of the Funds Control Process, FY 1993 Air Force Consolidated Financial Statements (Report No. 94053030), August 26, 1994.

Review of Management Initiatives to Improve Financial Reporting, FY 1993 Air Force Consolidated Financial Statements (Report No. 94053021), August 8, 1994.

Review of Overview and Performance Measures, FY 1993 Air Force Consolidated Financial Statements (Report No. 94053029), August 8, 1994.

Review of Civilian Payroll, FY 1993 Air Force Consolidated Financial Statements (Report No. 93053014), June 6, 1994.

Review of Military Personnel Costs, FY 1993 Air Force Consolidated Financial Statements (Report No. 93053013), July 1, 1994.

Air Force FY 1994 General Fund Financial Statements

Opinion on FY 1994 Air Force Consolidated Financial Statements (Report No. 94053001), March 1, 1995.

Review of Property, Plant, and Equipment, FY 1994 Air Force Consolidated Financial Statements (Report No. 94053032), August 10, 1995.

Review of the Fund Control Process, FY 1994 Air Force Consolidated Financial Statements (Report No. 94053033), February 5, 1996.

Review of Operating Materials and Supplies, FY 1994 Air Force Consolidated Financial Statements (Report No. 94053034), June 27, 1995.

Review of Military and Civilian Pay, FY 1994 Air Force Consolidated Financial Statements (Report No. 94053035), April 24, 1995.

Review of Contingent Liabilities, FY 1994 Air Force Consolidated Financial Statements (Report No. 94053037), May 1, 1995.

Air Force FY 1995 General Fund Financial Statements

Opinion on Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 95053001), March 1, 1996.

Review of Civilian Pay, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 96053012), April 1, 1996.

Review of Contingent Liabilities, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 96053013), April 18, 1996.

Efforts to Improve Air Force Financial Management (Report No. 95053009), July 9, 1996.

**Appendix C. Audit Reports Issued for the FYs 1993, 1994, and 1995
General Fund Financial Statements**

Review of Military Pay, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 95053004), July 25, 1996.

Review of Property, Plant, and Equipment, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 95053002), June 13, 1996.

Review of Cash Operations, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 96053014), June 17, 1996.

Review of Operating Materials and Supplies, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 95053005), August 29, 1996.

Review of Weapon System Progress Payments, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 96053010), June 14, 1996.

Review of the Fund Control Process, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 95053003), June 27, 1996.

Review of Government Furnished Property, Fiscal Year 1995 Air Force Consolidated Financial Statements (Report No. 96053011), October 22, 1996.

Appendix D. Data From FYs 1994 and 1995 General Fund Financial Statements

FY 1994 Statement of Financial Position (page 1 of 4) (Millions)

<u>Assets</u>	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
1. Entity Assets:				
a. Transactions With Federal Entities:				
(1). Fund Balances With Treasury	\$ 29,938	\$ 58,605	\$ 2,315	\$ 90,858
(2). Investments, Net	1	0	219	220
(3). Accounts Receivable, Net	799	1,313	321	2,433
(4). Interest Receivable	0	0	2	2
(5). Advances and Prepayments	641	4	0	645
(6). Other Federal (Intragovernmental)	0	0	(2)	(2)
b. Transactions With Non-Federal Entities:				
(1). Investments	0	0	0	0
(2). Accounts Receivable, Net	272	86	1,024	1,382
(3). Credit Program Receivables	0	0	0	0
(4). Interest Receivable, Net	0	0	0	0
(5). Advances and Prepayments	867	10,047	2	10,916
(6). Other Non-Federal (Governmental)	0	0	(159)	(159)
c. Cash and Other Monetary Assets	193	0	4	197
d. Inventory, Net	2,010	0	0	2,010
e. Work-in-Process	0	0	0	0
f. Operating Material/Supplies, Net	0	31,098	17	31,115
g. Stockpile Materials, Net	30,461	0	0	30,461
h. Seized Property	0	0	0	0
i. Forfeited Property, Net	0	0	0	0
j. Goods Held Under Price Support	0	0	0	0
k. Property, Plant, and Equipment, Net	160,373	223,762	44,491	428,626
l. Other Entity Assets	<u>7,196</u>	<u>0</u>	<u>26</u>	<u>7,222</u>
m. Total Entity Assets	\$232,751	\$324,915	\$48,260	\$605,926

FY 1994 Statement of Financial Position (page 2 of 4)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
2. Nonentity Assets:				
a. Transactions With Federal Entities:				
(1). Fund Balance With Treasury	\$ 924	\$ 54	\$ 52	\$ 1,030
(2). Accounts Receivable, Net	0	0	1	1
(3). Interest Receivable, Net	0	0	0	0
(4). Other	0	0	0	0
b. Transactions With Non-Federal Entities:				
(1). Accounts Receivable, Net	23	743	1	767
(2). Interest Receivable, Net	0	0	0	0
(3). Other	0	4	0	4
c. Cash and Other Monetary Assets	0	140	0	140
d. Other Nonentity Assets	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
e. Total Nonentity Assets	\$ 947	\$ 941	\$ 55	\$ 1,943
3. Total Assets	\$233,698	\$325,856	\$48,314	\$607,868
	<u>Liabilities</u>			
4. Liabilities Covered by Budgetary Resources:				
a. Transactions With Federal Entities:				
(1). Accounts Payable	\$2,319	\$1,503	\$161	\$ 3,983
(2). Interest Payable	0	0	0	0
(3). Debt	0	0	0	0
(4). Other Federal Liabilities	1,556	1,124	204	2,884

FY 1994 Statement of Financial Position (page 3 of 4)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
b. Transactions With Non-Federal Entities:				
(1). Accounts Payable	\$ 64	\$ 2,775	\$ 422	\$ 3,261
(2). Accrued Payroll and Benefits:				
(a). Salaries and Wages	1,236	488	0	1,724
(b). Annual Accrued Leave	0	0	0	0
(c). Severance Pay and Separation Allowance	191	19	210	525
(3). Interest Payable	0	0	0	0
(4). Liabilities for Loan Guarantee	0	0	0	0
(5). Lease Liabilities	0	0	0	0
(6). Pensions/Other Actuarial Liabilities	0	0	0	0
(7). Other Non-Federal Liabilities	<u>364</u>	<u>4</u>	<u>480</u>	<u>848</u>
c. Total Liabilities Covered by Budgetary Resources	\$5,730	\$5,912	\$1,268	\$12,910
5. Liabilities Not Covered by Budgetary Resources:				
a. Transactions With Federal Entities:				
(1). Accounts Payable	\$ 352	\$ 0	\$ 0	\$ 352
(2). Debt	0	0	0	0
(3). Other Federal Liabilities	0	0	0	0
b. Transactions With Non-Federal Entities:				
(1). Accounts Payable	0	0	0	0
(2). Debt	0	0	0	0
(3). Lease Liabilities	0	0	22	0
(4). Pensions/Other Actuarial Liabilities	0	0	0	0
(5). Other Non-Federal Liabilities	<u>1,808</u>	<u>1,606</u>	<u>7</u>	<u>3,422</u>
c. Total Liabilities Not Covered by Budgetary Resources	\$2,160	\$1,606	\$ 29	\$ 3,795
6. Total Liabilities	\$7,890	\$7,518	\$1,296	\$16,704

FY 1994 Statement of Financial Position (page 4 of 4)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
<u>Net Position</u>				
7. Balances:				
a. Unexpended Appropriations	\$ 28,855	\$ 55,177	\$ 2,903	\$ 86,935
b. Invested Capital	197,562	264,769	86,614	548,945
c. Cumulative Results of Operations	1,147	0	(34,343)	(33,196)
d. Other	405	1	(8,156)	(7,750)
e. Future Funding Requirements	<u>(2,160)</u>	<u>(1,608)</u>	<u>0</u>	<u>(3,768)</u>
f. Total Net Position	\$225,809	\$318,339	\$47,018	\$591,166
8. Total Liabilities and Net Position	\$233,698	\$325,856	\$48,314	\$607,868

FY 1994 Statement of Operations and Changes in Net Position (Page 1 of 2)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
<u>Revenues and Financing Sources</u>				
1. Appropriated Capital Used	\$55,610	\$56,023	\$ 6,245	\$117,878
2. Revenues From Sale of Goods:				
a. To the Public	1,112	226	259	1,597
b. Intragovernmental	5,177	5,013	3,127	13,317
3. Interest and Penalties, Non-Federal	0	0	0	0
4. Interest, Federal	0	0	9	9
5. Taxes	0	0	0	0
6. Other Revenues and Financing Sources	888	2	148	1,038
7. Less: Taxes and Receipts Transferred to Treasury or Other Agencies	<u>(381)</u>	<u>0</u>	<u>98</u>	<u>283</u>
8. Total Revenue and Financing Sources	\$62,407	\$61,264	\$133,361	\$126,106
<u>Expenses</u>				
9. Program or Operating Expenses	\$56,136	\$55,126	\$8,929	\$120,191
10. Cost of Goods or Services Sold:				
a. To the Public	1,023	226	165	1,414
b. Intragovernmental	5,266	5,013	363	10,642
11. Depreciation	0	0	295	295
12. Bad Debts and Write-offs	55	132	0	187
13. Interest:				
a. Federal Financing	0	0	0	0
b. Federal Securities	0	0	0	0
c. Other	2	2	0	4
14. Other Expenses	<u>307</u>	<u>657</u>	<u>0</u>	<u>964</u>
15. Total Expenses	\$62,788	\$61,155	\$9,752	\$133,695

FY 1994 Statement of Operations and Changes in Net Position (Page 2 of 2)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Adjustments	\$ (382)	\$109	\$ (62)	\$ (335)
17. Plus (Minus) Extraordinary Items	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	\$ (382)	\$109	\$ (62)	\$ (335)
19. Net Position, Beginning Balances	\$231,027	\$320,466	\$49,189	\$ 600,682
20. Adjustments	<u>72</u>	<u>0</u>	<u>0</u>	<u>72</u>
21. Net Position, Beginning Balances Restated	\$231,100	\$320,466	\$49,189	\$6,001,755
22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	\$ (382)	\$ 109	\$ (62)	\$ (335)
23. Plus (Minus) Non-Operating Changes	<u>(4,909)</u>	<u>(2,236)</u>	<u>(2,109)</u>	<u>(9,254)</u>
24. Net Position, Ending Balances	\$225,809	\$318,339	\$47,018	\$591,166

FY 1995 Statement of Financial Position (page 1 of 4)
(Millions)

<u>Assets</u>	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
1. Entity Assets:				
a. Transactions With Federal Entities:				
(1). Fund Balances With Treasury	\$ 29,661	\$ 54,781	\$ 1,890	\$ 86,332
(2). Investments, Net	1	0	241	242
(3). Accounts Receivable, Net	977	1,363	342	2,682
(4). Interest Receivable	0	0	1	1
(5). Advances and Prepayments	90	3	0	93
(6). Other Federal (Intragovernmental)	0	0	3	3
b. Transactions With Non-Federal Entities:				
(1). Investments	0	0	0	0
(2). Accounts Receivable, Net	180	187	628	995
(3). Credit Program Receivables	0	0	0	0
(4). Interest Receivable, Net	0	0	0	0
(5). Advances and Prepayments	920	8,121	2	9,043
(6). Other Non-Federal (Governmental)	0	0	(102)	(102)
c. Cash and Other Monetary Assets	270	0	0	270
d. Inventory, Net	1,896	0	0	1,896
e. Work-in-Process	0	0	0	0
f. Operating Material/Supplies, Net	0	23,936	13	23,949
g. Stockpile Materials, Net	31,265	0	0	31,265
h. Seized Property	0	0	0	0
i. Forfeited Property, Net	0	0	0	0
j. Goods Held Under Price Support	0	0	0	0
k. Property, Plant, and Equipment, Net	155,943	234,478	38,959	429,380
l. Other Entity Assets	<u>153</u>	<u>0</u>	<u>28</u>	<u>181</u>
m. Total Entity Assets	<u>\$221,356</u>	<u>\$322,870</u>	<u>\$42,005</u>	<u>\$586,231</u>

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(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
b. Transactions With Non-Federal Entities:				
(1). Accounts Payable	\$1,308	\$3,990	\$ 413	\$ 5,711
(2). Accrued Payroll and Benefits:				
(a). Salaries and Wages	1,117	475	0	1,592
(b). Annual Accrued Leave	0	0	0	0
(c). Severance Pay and Separation Allowance	508	17	0	525
(3). Interest Payable	0	0	0	0
(4). Liabilities for Loan Guarantee	0	0	0	0
(5). Lease Liabilities	0	0	0	0
(6). Pensions/Other Actuarial Liabilities	0	0	0	0
(7). Other Non-Federal Liabilities	<u>191</u>	<u>2</u>	<u>1,045</u>	<u>1,238</u>
c. Total Liabilities Covered by Budgetary Resources	\$5,616	\$6,471	\$1,813	\$13,900
5. Liabilities Not Covered by Budgetary Resources:				
a. Transactions With Federal Entities:				
(1). Accounts Payable	\$ 352	\$ 0	\$ 0	\$ 352
(2). Debt	0	0	0	0
(3). Other Federal Liabilities	0	0	0	0
b. Transactions With Non-Federal Entities:				
(1). Accounts Payable	0	0	0	0
(2). Debt	0	0	0	0
(3). Lease Liabilities	0	0	0	0
(4). Pensions/Other Actuarial Liabilities	0	0	0	0
(5). Other Non-Federal Liabilities	<u>1,910</u>	<u>1,813</u>	<u>16</u>	<u>3,739</u>
c. Total Liabilities Not Covered by Budgetary Resources	\$2,263	\$1,813	\$ 16	\$ 4,092
6. Total Liabilities	\$7,879	\$8,284	\$1,829	\$17,992

FY 1995 Statement of Financial Position (page 4 of 4)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
<u>Net Position</u>				
7. Balances:				
a. Unexpended Appropriations	\$ 27,966	\$ 50,868	\$ 1,771	\$ 80,605
b. Invested Capital	190,559	266,434	38,456	495,449
c. Cumulative Results of Operations	(2,422)	0	2	(2,420)
d. Other	0	2	0	2
e. Future Funding Requirements	<u>(2,263)</u>	<u>(1,774)</u>	<u>0</u>	<u>(4,037)</u>
f. Total Net Position	\$213,841	\$315,529	\$40,230	\$569,600
8. Total Liabilities and Net Position	\$221,719	\$323,812	\$42,059	\$587,590

FY 1995 Statement of Operations and Changes in Net Position (Page 1 of 2)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
<u>Revenues and Financing Sources</u>				
1. Appropriated Capital Used	\$53,273	\$55,310	4,544	\$113,127
2. Revenues From Sale of Goods:				
a. To the Public	495	191	14	700
b. Intragovernmental	5,467	3,371	2,781	11,619
3. Interest and Penalties, Non-Federal	0	0	0	0
4. Interest, Federal	0	0	13	13
5. Taxes	0	0	0	0
6. Other Revenues and Financing Sources	912	37	117	1,066
7. Less: Taxes and Receipts Transferred to Treasury or Other Agencies	<u>321</u>	<u>0</u>	<u>98</u>	<u>419</u>
8. Total Revenue and Financing Sources	\$59,826	\$58,909	\$7,371	\$126,106
<u>Expenses</u>				
9. Program or Operating Expenses	\$54,476	\$54,629	6,655	\$115,760
10. Cost of Goods or Services Sold:				
a. To the Public	495	191	14	700
b. Intragovernmental	5,467	3,371	517	9,355
11. Depreciation	0	0	181	181
12. Bad Debts and Write-offs	37	6	26	69
13. Interest:				
a. Federal Financing	0	0	0	0
b. Federal Securities	0	0	0	0
c. Other	1	3	0	4
14. Other Expenses	<u>358</u>	<u>874</u>	<u>0</u>	<u>1,232</u>
15. Total Expenses	\$60,834	\$59,075	\$7,368	\$127,277

FY 1995 Statement of Operations and Changes in Net Position (Page 2 of 2)
(Millions)

	<u>Army</u>	<u>Air Force</u>	<u>Corps of Engineers</u>	<u>Total</u>
16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Adjustments	\$ (1,008)	\$ (165)	\$3	\$ (1,170)
17. Plus (Minus) Extraordinary Items	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	\$ (1,008)	\$ (165)	\$3	\$ (1,170)
19. Net Position, Beginning Balances	225,809	318,339	47,018	591,166
20. Adjustments	<u>3</u>	<u>0</u>	<u>0</u>	<u>3</u>
21. Net Position, Beginning Balances Restated	\$225,811	318,339	\$47,018	\$591,680
22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	(1,008)	(165)	3	(1,170)
23. Plus (Minus) Non-Operating Changes	<u>(10,962)</u>	<u>(2,644)</u>	<u>(6,791)</u>	<u>(20,397)</u>
24. Net Position, Ending Balances	\$213,841	\$315,529	\$40,230	\$569,600

Appendix E. Key Accounting Requirements and Budget Accounting Classification Code

The DFAS established 13 key accounting requirements that all interim migratory accounting systems must implement as part of the General Fund Interim Migratory Accounting Strategy. The interim migratory accounting systems must also use the standard Budget Accounting Classification Code.

Key Accounting Requirements

General Ledger Control and Financial Reporting. A system must have general ledger control and maintain an appropriate account structure approved by DoD. The general ledger account structure must follow the general ledger accounts for assets, liabilities, equity, expenses, losses, gains, transfers in and out, and sources of financing. A double-entry set of accounts must be maintained to reflect budget authority, undelivered orders, obligations, expenditures, and other necessary accounts. The system must list both control accounts and subsidiary general ledger accounts by titles and numbers, and must define each account. Subsidiary accounts must be reconciled to the control accounts at least monthly. Full financial disclosure, accountability, adequate financial information, and reports must be provided for management purposes, and for reporting to OMB and the Department of the Treasury. General ledger control and financial reports apply to all DoD systems (including stock, industrial, and trust funds) except for pay delivery systems.

Property and Inventory Accounting. A system must account in quantitative and monetary terms for the procurement, receipt, issue, and control of plant property, equipment, inventory, and material. Most acquisitions are recorded upon receipt of goods. When property and equipment (including automated data processing software) has an acquisition cost or estimated acquisition cost equal to or exceeding the expense or investment funding threshold used by Congress for DoD operating and procurement appropriations, and has an estimated useful life of more than 2 years, it must be capitalized and reported at cost, including amounts paid to install the assets. If the acquisition cost is unknown, the fair value of the fixed asset at the date of acquisition is estimated. Costs of additions, alterations, or replacements that extend the asset's useful life or service capacity are capitalized as fixed assets. Proper accounting controls must exist for Government-owned property held and used by contractors.

Inventory accounting must entail accounting and control over the acquisition and issuance of materials, the comparison of physical inventories and records, planning for procurement and utilization, and effective custody of materials. A property management system must include accounting controls over inventory ledgers that identify the item, its location, quantity, acquisition date, cost, and other information. Subsidiary property records are reconciled periodically to

Appendix E. Key Accounting Requirements and Budget Accounting Classification Code

general ledger accounts. Physical controls include assigning specific individuals to inventory, placing physical safeguards on inventory, and periodically reconciling physical inventories to the accounting records.

Accounting for Receivables Including Advances. A system must account for all accounts receivable (any public indebtedness to the U.S. Government). Accounts receivable must be recorded accurately and promptly to provide timely and reliable financial information. Accounts receivable must be reduced upon collection of funds or when offset by previously established collateral. Uncollectible amounts must be promptly written off and the accounts receivable reduced accordingly. An allowance for uncollectible accounts and corresponding expenses must be established to provide full financial disclosure. The process should document the efforts made to collect delinquent debts, including compliance with the Debt Collection Act. All collections must be under general ledger accounting control. Cash must be deposited as quickly as possible and immediately recorded in the accounting records. Advances must be recorded as assets until goods or services are received or contract terms are met. Accounting control must be maintained over advances made to employees, contractors, and all others. Advances must be promptly recorded and reconciled to general ledger control accounts.

Cost Accounting. Cost accounting must include accounting analysis and reporting on the costs of producing goods or services or operating programs, activities, functions, or organizational units. Cost accounting must be provided in the accounting system if required to make pricing decisions or productivity improvement decisions, to measure performance or compare the efficiency of similar activities, and in industrial fund activities. For industrial fund activities, DoD requires that working capital funds provide capital for industrial and commercial activities. Industrial fund accounting shall provide an effective means of controlling the cost of goods and services produced or furnished by industrial and commercial activities. Cost accounting must be used in job order costing and process costing and in determining operating results. The primary components of DoD costs are labor and materials. However, other costs, including depreciation; amortization; and unfunded liabilities such as severance pay, labor, manufacturing overhead, and unallocated costs, should be accumulated in the accounting system when needed.

Accrual Accounting. Accrual accounting must recognize the accountable aspects of financial transactions or events as they occur. Transactions may be recorded in accounting records as they occur or may be adjusted to the accrual basis at the end of each month. Accrual accounting must be used to meet the specific needs of management and the Congress. Amounts of accrued expenditures and revenues must be recorded only when supported by prescribed documentary evidence on the basis of the initial documentation received. They are to be adjusted subsequently, if necessary, upon receipt of more accurate documentation. Examples of acceptable initial documentation include receiving reports, bills of lading, job sheets, certified unpaid invoices, and journal vouchers showing administrative estimates by responsible officials. This documentation must show transactions and performance that actually occur. When liabilities are incurred as work is performed rather than when deliveries are made, accruals must be recorded from performance reports for the affected

Appendix E. Key Accounting Requirements and Budget Accounting Classification Code

accounting period. Unpaid personnel compensation and benefits that have been earned as of the end of the pay year must be accrued in full or in part. For example, the accrual of annual leave is material and should be recognized annually in the financial statements. Civilian and military payroll accrued for salaries and wages, the employer's share of fringe benefits, allowances, salaries paid to foreign nationals, severance pay, unfunded annual leave, annual leave, and retirement must be recorded and reconciled with actual payroll.

Military and Civilian Payroll Procedures. Wherever feasible, DoD must use modern technology in its computer systems to process payroll transactions. The payroll system must interface with the accounting system that provides obligation and accrual data. The military and civilian payroll processes and procedures must be available to management, users, auditors, and evaluators.

Payroll systems must incorporate controls of both gross and net payroll amounts and payroll deductions to ensure smooth payroll processing and minimize incorrect payments. Procedures must ensure that only authorized deductions are made from pay and all deductions are supported by proper documentation. Accounting entries for authorized deductions from pay must be verified. Timely, accurate, and complete individual and subsidiary records must be maintained for leave accounts, employee benefits, compensated personnel absences, general benefits (such as bonuses and cash allowances for quarters and subsistence), allotments by type and amount, and other balances. The general ledger and personnel records must be reconciled to payroll records. Unpaid personnel compensation and benefits, including annual leave, which employees have earned at the end of the pay year, must be accrued in full. Accrued payroll must be reconciled with actual payroll. Personal compensation and all employee benefit expenses (including Federal contributions) must be reported and disclosed separately in financial statements. Automated controls must include predetermined limits on the computation of pay, accumulation and tests of zero balances, checks on the sequence of records, record counts, checks on the equality of general ledger and subsidiary ledger balances, and other tests of the validity of data or the accuracy of processing. For separation of duties, vouchers authorizing payment must be certified before payment by an authorized certifying officer who does not compute amounts payable, maintain the payroll records, or distribute the paychecks.

System Controls. System controls are divided into fund controls and internal controls. The following paragraphs give details on fund controls and internal controls.

Fund Controls. A system must ensure that obligations and expenditures do not exceed the amount appropriated, apportioned, reapportioned, allocated and allotted (the Antideficiency Act, title 31, United States Code). A system must have procedures for control over errors to ensure that once errors are detected, corrections are made in a timely manner and reentered into the appropriate processing cycle, corrections are made only once, and each correction is validated. A system must show the appropriations and funds to be accounted for and must describe the accounting entity's process for distribution and control of funds. A system must have good fund control procedures to prevent untimely liquidation of obligations, unmatched expenditures, and

Appendix E. Key Accounting Requirements and Budget Accounting Classification Code

undistributed disbursements. Obligations must be recorded immediately. At the end of each fiscal year, fund control procedures must require a certification of data by a senior accounting official to ensure the validity of all obligations and unobligated balances. Administrative fund control must ensure that funds are used economically, efficiently, and only for properly authorized purposes.

Internal Controls. A system must have adequate internal controls to prevent, detect, and correct errors and irregularities that may occur throughout the system. Separation of duties and responsibilities must be maintained for initiating, authorizing, processing, recording, and reviewing transactions. An automated system must have system security and integrity for authorized processing, including procedures and controls to protect hardware, software, and documentation from being damaged by accident, fire, flood, environmental hazards, and unauthorized access. A system must also have controls to prevent the unauthorized use of confidential information.

Audit Trails. Audit trails allow transactions to be traced through a system. Audit trails allow auditors or evaluators to ensure that all transactions are properly accumulated and correctly classified, coded, and recorded. Audit trails must allow transactions to be traced from initiation through processing to final reports. Good audit trails allow for the detection and tracing of rejected or suspended transactions, such as unmatched disbursements, so that the system can be corrected within a reasonable period. A fundamental requirement for any compliant accounting system is that the transactions for which the system accounts must be adequately supported with pertinent documents and source records. All transactions, including those that are computer-generated and computer-processed, must be traceable to individual source records. Audit trails allow the tracing or replicating of a transaction from its source to the resulting record or report, and from the resulting record or report to the source. Items needed for audit trails include transaction type, record or account involved, amount, transaction posting references (to reference the general ledger back to the subsidiary ledgers), and identification of the preparer and approver of the transaction. A key test of the adequacy of an audit trail is whether tracing the transaction forward from the source or back from the result will permit verification of the amount recorded or reported.

Cash Procedures and Accounts Payable. A system must be designed to ensure that payments are timely and are based on properly approved disbursement documents. Payment process and procedures must comply with the Prompt Payment Act. Cash discounts should be taken when they are financially advantageous to DoD. Accounts payable are liabilities that must be recorded when goods or services are received. The liability reported in the annual financial statements must reflect amounts due for goods and services received. For items that a contractor manufactures to specifications, the accounting system must reflect the appropriate payable (including contract retentions) for each accounting period, based on requests for progress payments or on reasonable estimates of unbilled contractor performance. This must be recorded in the proper accounting period. Accounts payable for services performed by employees, contractors, and others shall be determined based on performance as shown by payroll records, progress billings, or other data. In the absence of invoices or other available data, reasonable estimates of the cost

Appendix E. Key Accounting Requirements and Budget Accounting Classification Code

of services performed before the end of a reporting period shall be made for annual financial reporting purposes. The system shall record the liability for goods and services purchased under a long-term contract in the period in which the goods or services are received or accepted.

System Documentation. An accounting system must have adequate system documentation. The system documentation must address the interfaces between segments of the accounting system. The documentation of the accounting system must adequately address the functional user's accounting requirements. Such documentation must be available in user manuals and subsystem specifications. User documentation must be comprehensive and must include descriptions of processes, flowcharts and narrative description, diagrams, basic accounting entries (including adjusting and closing entries), illustrations or samples of source documents for input, and sample outputs and reports. Documentation must also cover the accounting system's internal controls, and must show conformance with DoD requirements for adequate and reasonable documentation. The documentation must be understandable by the computer personnel and system accountants who develop software or review process flow. It must demonstrate readily to users, auditors, and evaluators the system's processes and procedures. The documentation should facilitate maintenance on the systems and transaction testing. Good documentation permits transaction testing, which is designed to disclose whether valid transactions are processed properly and whether the system rejects invalid transactions. The documentation must be detailed enough that, when testing the system, a transaction could be followed from initial authorization through processing, posting to the accounts, and reporting. The documentation must indicate the mission, organization, description, objectives, financial management requirements, and boundaries of the system.

System Operations. Adequate organization and planning must exist regarding system operations to ensure that financial management and accounting objectives are met economically and efficiently. Financial systems must satisfy legal requirements, laws, regulations, accounting principles and standards, and related requirements as prescribed by the General Accounting Office, OMB, and DoD. Financial systems must contain all data required to achieve the purposes for which they were created and maintained, must be as simple as possible, and must be consistent with regulatory requirements and users' needs. The existing and planned hardware must be able to process current and projected future transactions efficiently. Existing and planned hardware must interface effectively with other systems. A system must meet DoD requirements for documentation. The best acceptably priced current technology must be used. There must be detailed procedures for system operations and maintenance. Also, periodic system reviews must ensure that a system is functioning as intended, that required procedures are being followed, that any operating problems are promptly identified and corrected, and that enhancements are incorporated as appropriate.

Users' Information Needs. Users' information needs and requirements for quality, accuracy, timeliness, reliability, and responsiveness of the system must be adequate in response to program managers, financial managers, and other users. A system must satisfy users' reporting requirements, particularly for

Appendix E. Key Accounting Requirements and Budget Accounting Classification Code

month-end reports. A system must also satisfy users' needs to facilitate decisionmaking by management. In addition, if there are departures from other key accounting requirements that adversely affect the users of the system, the materiality of these departures will be determined under this key accounting requirement.

Budgetary Accounting. A system shall support formulation of the budget, support budget requests, and control budget execution. Programming, budgeting, accounting, reporting classifications, and coding structure must be uniform, consistent, and synchronized with the organizational structure so that activity reported by the accounting system can be compared with enacted budgets and can support future budget formulation. Presidential, Congressional, and OMB decisions must be recorded in the system, and the financial management data and results must be appropriately classified to track such decisions. The system must record budget resources at the appropriate level and must account for appropriations, reappropriations, apportionments, allocations, transfers, allotments of budget authority, customer orders, reimbursables, and other appropriate accounts prescribed by DoD.

Budget Accounting Classification Code

The development and use of a standard Budget Accounting Classification Code was approved by the USD(C) in September 1994. The Budget Accounting Classification Code will be a consistent structure for financial data and will ensure the reporting of comparable and consistent financial information. The Budget Accounting Classification Code comprises fiduciary reporting information that identifies the Military Department, fiscal year, or appropriation involved; gives the data needed to ensure that applicable information can be identified and referenced to other related information, including the organization, document, or transaction to which the information applies; and includes various other financial information required for informational, reporting, and management purposes.

Appendix F. General Fund Interim Migratory Accounting Strategy

A previous audit identified deficiencies in DoD accounting systems as the major reason that accounting information on the DoD General Funds is unreliable and unsupported. As a result, auditors are unable to render opinions on General Fund financial statements. DFAS established the General Fund Interim Migratory Accounting Strategy (the strategy) to decrease the number of accounting systems and correct deficiencies in those systems by the end of FY 1997. The long-term objective of DFAS is to implement a single, integrated DoD-wide General Fund accounting system after initially migrating to a smaller number of accounting systems. The IG, DoD, evaluated the DFAS strategy. The audit reviewed the reasonableness of objectives, time frames, and costs of achieving auditable DoD General Fund financial statements. The results of the audit were published in IG, DoD, Report No. 96-180, "The General Fund Interim Migratory Accounting Strategy," June 26, 1996. The following summarizes the audit results, recommendations, management comments, and the IG, DoD, response to management comments.

Audit Results. The report concluded that the initial DFAS strategy would have resulted in a duplication of effort through migration (corrected and used as opposed to replaced) of multiple, Service-unique accounting systems. This is because systems would have been modified, not replaced. The Service-unique approach used for the strategy did not fully support DoD Corporate Information Management Initiatives and Defense Management Review Decision 910, and did not meet the requirements of OMB Circular A-127 and the Joint Financial Management Improvement Program. Also, the strategy was completely unable to produce compliant accounting systems in the near future.

In FY 1995, DFAS made some progress in decreasing the number of accounting systems, which should reduce annual operating expenses in the future. However, little or no progress was made in correcting accounting system deficiencies to comply with the 13 key accounting requirements (see Appendix E for the 13 key accounting requirements). As a result, DFAS had already spent \$36 million of Defense Business Operations Fund - Capital Funds in FY 1995, and could have inefficiently spent at least another \$187 million attempting to migrate to four noncompliant suites (consisting of nine separate systems) of Service-unique General Fund accounting systems. The initial strategy involved a high risk that DFAS would not be able to make the four Service-unique suites of accounting systems compliant before the available Defense Business Operations Fund - Capital Funds were spent. There was also a risk that DoD would be unable to produce auditable DoD Consolidated Financial Statements from noncompliant systems for several more years.

The report concluded that a standard core General Fund accounting system could be selected for DoD-wide use and implemented within approximately the same time frames that the multiple, Service-unique approaches could eventually require. The personnel, funds, and time needed to eventually complete the strategy would be better used if directed at achieving the ultimate goal of a

Appendix F. General Fund Interim Migratory Accounting Strategy

single, DoD-wide compliant General Fund accounting system instead of attempting to redesign and modify multiple, Service-unique, noncompliant accounting systems. The report concluded that canceling the strategy would avoid spending the personnel resources, time, and funds needed to correct multiple accounting systems, of which only one will eventually be selected for long-term use throughout DoD. Because of the nature of the finding and recommendations, the report was discussed with the USD(C); the Director, DFAS; and senior financial managers of the Army, the Navy, the Air Force, and the Marine Corps. The USD(C) may encounter significant obstacles in convincing all of the Services to convert in the future to a single DoD-wide system. However, the report stated that the initial plan, continuing to invest in multiple redundant systems, was unlikely to produce sufficient progress; a more aggressive approach was needed.

Summary of Recommendations. The reports recommended that the strategy be canceled and that a single DoD-wide system approach be adopted for General Fund accounting. The report also recommended that a centralized program management structure be established to direct the selection and implementation of the DoD-wide accounting system.

Management Comments. The Deputy Chief Financial Officer, DoD, stated that the recommendations to cancel the strategy and implement a single-system approach had merit. However, he nonconcurred, stating that the current strategy was more cost-effective, would provide benefits sooner, would require less time, and was less risky. The Deputy Chief Financial Officer partially concurred with the recommendation to establish a program management structure to oversee accounting systems development. The Director, DFAS, issued a memorandum on April 17, 1996, announcing the establishment of a program management office. However, that office will not focus on a single-system approach.

Audit Response. The management actions in response to the audit were quite responsive, although the written comments strongly defended the strategy that we had reviewed. The USD(C) and DFAS have made significant progress in establishing a good systems development management concept and moving DoD towards a single-system approach for General Fund accounting. For example, on May 28, 1996, the USD(C) drastically altered the initial strategy by designating the Corps of Engineers Financial Management System as the migration system for Army General Fund accounting. On July 25, 1996, the USD(C) directed DFAS to proceed with the development of the Corps of Engineers Financial Management System as the General Fund migratory accounting system for the DFAS Denver Center's customers (the Air Force is that DFAS Denver Center's main customer). These two management actions could redirect \$107 million of the \$187 million that was once designated for consolidating Service-unique systems.

Appendix G. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller), Washington, DC

Department of the Army

U.S. Army Audit Agency, Alexandria, VA

Department of the Air Force

Air Force Audit Agency, March Air Reserve Base, CA

Other Defense Organizations

Defense Finance and Accounting Service, Arlington, VA

Defense Finance and Accounting Service Indianapolis Center, Indianapolis, IN

Appendix H. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Acquisition and Technology)
Deputy Under Secretary of Defense (Logistics)
Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Health Affairs)
Assistant to the Secretary of Defense (Public Affairs)
General Counsel of the Department of Defense

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army
Commander, U.S. Army Corps of Engineers

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
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

Other Defense Organizations

Director, Ballistic Missile Defense Organization
Director, Defense Advanced Research Projects Agency
Director, Defense Commissary Agency
Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Finance and Accounting Service Cleveland Center
Director, Defense Finance and Accounting Service Columbus Center
Director, Defense Finance and Accounting Service Denver Center
Director, Defense Finance and Accounting Service Indianapolis Center
Director, Defense Finance and Accounting Service Kansas City Center
Director, Defense Information Systems Agency
Director, Defense Intelligence Agency
Director, Defense Investigative Service
Director, Defense Logistics Agency
Director, Defense Medical Program Activity
Director, National Imagery and Mapping Agency
Director, National Security Agency
 Inspector General, National Security Agency
Director, Defense Special Weapons Agency
Director, On-Site Inspection Agency
Director, Joint Staff
Director, American Forces Information Service
Director, Office of the Civilian Health and Medical Program of the Uniformed Services
Director, Defense Prisoner of War/Missing in Action Office
Director, Defense Technology Security Administration
Director, Department of Defense, Dependent Schools
Director, Section 6 Schools
Director, Office of Economic Adjustment
Director, Washington Headquarters Services
President, Defense Acquisition University
President, Defense Systems Management College
President, Uniformed University of the Health Sciences

Non-Defense Federal Organizations

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

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 III - Management Comments

Under Secretary of Defense (Comptroller) Comments



COMPTROLLER

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



AUG 20 1996

Shaw

MEMORANDUM FOR INSPECTOR GENERAL, DOD

SUBJECT: Draft Audit Report on Major Deficiencies Preventing Auditors From Rendering Audit Opinions on FY 1995 Department of Defense (DoD) General Fund Financial Statements (Project No. SFI-2012.04)

This is in response to your staff's request for comments on the subject draft audit report. This office does not agree with the conclusions reached by the auditors concerning the findings for the "Basis of Accounting" and for "Contingent Liabilities" as cited in the report. The reasons for the nonoccurrence are explained in the attachment.

Additionally, the Executive Summary, on page ii, concludes that disclaimers of opinion can be expected well into the next century for the Army, the Navy, and the Air Force general fund statements, as well as for the DoD consolidated financial statements. The Department has stated in its Chief Financial Officer Financial Management 5-Year Plan (October 1995) that full compliance with the Chief Financial Officers Act cannot be expected in the near term. However, stretching "near term" into "well into the next century" does not appear to be adequately supported by findings in the audit report.

I am concerned with the conclusions contained in the report and request that your office reconsider the appropriateness of such Office of the Inspector General, DoD, comments as are addressed above and in the attachment.

My point of contact on this guidance is Mr. Oscar G. Covell. He may be reached at (703) 697-6149.


John J. Hamre

Attachment

cc: Director, DFAS

MAJOR DEFICIENCIES PREVENTING AUDITORS FROM
RENDERING AUDIT OPINIONS ON FY 1995
DOD GENERAL FUND FINANCIAL STATEMENTS
(PROJECT NO. 5FI-2012.04, DATED JUNE 28, 1996)

FINDINGS

DODIG FINDING--Basis of Accounting: On page 8, the auditors state that Office of Management and Budget (OMB) Bulletin 94-01, "Form and Content of Agency Financial Statements," specifies the form and content of financial statements prepared to meet the requirements of the CFO Act. This Bulletin incorporates a hierarchy of accounting principles to be used until a comprehensive set of accounting standards is issued by the Director, OMB, and the Comptroller General of the United States. In conflict with this policy, the Under Secretary of Defense (Comptroller) requires the Army to prepare its financial statements according to a hierarchy that begins with the "DoD Guidance on Form and Content of Financial Statements." The DoD guidance and the OMB guidance differ in several areas, such as the reporting of war reserves, and the reporting of contingent liabilities. Because the other conditions discussed above necessitated a disclaimer, auditors did not perform detailed work to quantify the effect of the DoD guidance.

DOD RESPONSE: Nonconcur. This office believes that its policies are consistent with the hierarchy of accounting standards issued by the OMB. The wording contained in the DoDIG report appears to have been paraphrased from an audit opinion contained in Army Audit Agency (AAA) Report AA 96-152, "Examination of the Army's Financial Statements for Fiscal Years 1995 and 1994 Auditor's Report," dated March 15, 1996. In turn, the statement in that audit report, at least in summary form, appears to have been taken from another audit opinion--AAA Report AA 96-154, "Examination of the Army's Financial Statements for Fiscal Years 1995 and 1994." Although, the audit opinion states that the Under Secretary of Defense (Comptroller) has established an accounting hierarchy different from that promulgated by the OMB, specific evidence to support that accusation is not provided. Further, the Under Secretary of Defense (Comptroller) was not provided an opportunity to comment on that allegation prior to the finalization of the AAA audit reports, or the current DoDIG draft report. This office believes that the current draft DoDIG audit report should be rewritten to delete this misleading statement. Alternatively, if the DoDIG believes that specific evidence is available to demonstrate the allegation, such evidence should be explicitly presented, and this office should be given an opportunity to address the allegation(s).

DODIG FINDING--Contingent Liabilities: Beginning on page 8, the auditors state that DoD policy prevents the Army from following OMB reporting requirements for probable contingent liabilities; consequently, a significant amount of liabilities are not recorded on the Army's Statement of Financial Position.

DOD RESPONSE: Nonconcur. The Department's policy for recording contingent liabilities mirrors the requirements contained in OMB Bulletin 94-01, dated November 13, 1993. The allegation that the policies promulgated by this office prevents the Army from complying with OMB guidance is from an old audit report. The allegation was not true then; and it is not true now. On June 23, 1994,

Under Secretary of Defense (Comptroller) Comments

this office replied (copy attached) to Army's FY 93 Financial Statements Audit Opinion Report--EXPOSURE DRAFT and advised that the cleanup costs causing a disclaimer, in part, were not contingent liabilities in the sense of OMB Bulletin 94-01 but, instead, were potential claims against future budgetary resources. The June 23, 1994, memorandum also advised that once new governmentwide standards were adopted and promulgated, the Department would implement those standards.

The Federal Accounting Standards Advisory Board (FASAB) only recently recommended accounting standards in this area. These standards were issued by the OMB in the Statement of Federal Financial Accounting Standard (SFFAS) No. 5 "Accounting for Liabilities of the Federal Government." Even more recently, the OMB issued the FASAB recommended standard in its Statement of Federal Financial Accounting Standard No. 6, "Accounting for Property, Plant, and Equipment." Until these recent publication of FASAB standards, and the acceptance of those standards by the OMB, there were no governmentwide standards to be followed, and the DoD standards were acceptable. Consistent with current OMB policy, the Department will continue to consider cleanup costs as potential claims against future budgetary resources through FY 1997. Beginning with FY 1998, the Department will implement SFFAS No. 6 as required by the OMB.

Additionally, it should be recognized that, during its deliberations, the FASAB determined that the recording of contingent liabilities was dependent not only upon liabilities being probable and measurable, but also on whether the contingencies were a Government Related Event or a Government Acknowledged Event. In addition, the FASAB determined that there was another class of contingent liabilities for which additional guidelines must be established. That additional class of contingent liabilities is "cleanup costs" associated with plant, property and equipment. It is these latter costs that the AAA adamantly has maintained that the Department should book as contingent liabilities. However, consistent with OMB guidance, those costs are potential claims on future resources--not contingent liabilities. The SFFAS No. 6 acknowledges that this class of contingent liabilities exists for which liabilities and expenses are recorded differently based upon whether cleanup costs are the result of the Government's use of General Property, Plant and Equipment or Federal Mission assets.

Under Secretary of Defense (Comptroller) Comments



OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

JUN 23 1994

MEMORANDUM FOR DIRECTOR, LOGISTICAL AND FINANCIAL AUDITS,
U.S. ARMY AUDIT AGENCY

SUBJECT: Army's FY 93 Financial Statements Audit Opinion Report--
EXPOSURE DRAFT

This memorandum responds to your memorandum of June 20, 1994, which requested that this office review the subject draft report and provide comments, if desired, to your office.

It is noted that the draft report states that the Army Audit Agency (AAA) cites an inability to express an opinion on the reliability of the Army's financial statements for a number of reasons. One of those reasons, according to the report, was that DoD policies prevented the Army from accurately reporting material amounts of assets (ammunition war reserves) and liabilities (contingent liabilities) in the Statement of Financial Position.

Even though the AAA may not agree with the Department's accounting policies on ammunition war reserves and contingent liabilities, nevertheless, those are the Department's current policies--which are applicable to all DoD Components, including the Army. Inasmuch as the Army's FY 1993 financial statements were produced in accordance with the Department's existing policies for reporting ammunition war reserves and contingent liabilities, the Department does not consider the AAA's views in these two areas as a valid reason for failing to express an opinion on the Army's financial statements.

It is requested that you modify page 5 of the draft report to delete the statement "DoD policies prevented the Army from accurately reporting material amounts of assets and liabilities in the Statement of Financial Position" as a reason for the AAA not expressing an opinion on the Army's FY 1993 financial statements. Attached are this office's specific comments regarding the reporting of ammunition war reserves and contingent liabilities.

We appreciate the opportunity to comment on this draft report. Should you have questions on this matter, please contact Mr. De W. Ritchie. He may be reached on (703) 693-6520.

Alvin Tucker
Deputy Chief Financial Officer

Attachment

cc: ODoDIG

AP-130

Under Secretary of Defense (Comptroller) Comments

OFFICE OF THE DOD COMPTROLLER
COMMENTS ON
ARMY AUDIT AGENCY DRAFT REPORT, "AUDIT OF THE ARMY'S
FY 1993 FINANCIAL STATEMENTS" (REPORT NO. HQ 94-XXX)

A-1 Recommendation: Adjust current policy regarding disclosure requirements for contingent liabilities to conform with the Office of Management and Budget requirements. The revised policy should require that probable contingent liabilities be recorded in the Statement of Financial Position, and that probable, and reasonably possible contingent liabilities, be disclosed in the footnotes to the financial statements.

DoD Response. Nonconcur. The contingent liabilities that the Army Audit Agency is requesting the Department to recognize in the Army FY 1993 Statement of Financial Position fall more into the category of potential claims against future budgetary resources, than into the category of contingent liabilities.

The Federal Accounting Standards Advisory Board (FASAB) is considering the issue of future claims against budgetary resources and has not yet recommended a method for handling this issue in governmental standards. Until the FASAB has made a recommendation that has been accepted and promulgated by the Office of Management and Budget, the Department holds to a policy that potential claims of this nature may be explained in the footnotes to the financial statement to the extent that the reporting DoD Component finds they can be reasonably determined without prejudice to any future legal proceedings. The rationale for this policy is:

- The claims for these costs are in doubt and may well be subject to negotiation and adjudication before a liability is firmly established.
- The amount of costs associated with these potential claims is at this point no more than a rough estimate.
- Future technology, as well as changes in environmental standards, can be expected to have major impacts on these estimates if, in fact, a liability is determined to exist.
- Amounts to cover these potential claims against future budgets have not been requested by the Department, nor authorized and appropriated by the Congress.

The FASAB is expected to issue a comprehensive set of all standards by March 1995.

A-2 Recommendation. Direct the Defense Finance and Accounting Service to record probable contingent liabilities in the Army's FY 1993 Statement of Financial Position.

DoD Response. Nonconcur. As stated above, until the FASAB has made a recommendation that has been accepted and promulgated by the Office of Management and Budget, it is the Department's policy that potential claims of this nature may be explained in the footnotes to the financial statement, to the extent that the Army finds they can be reasonably determined without prejudice to any future legal proceedings.

B-1 Recommendation. Revise existing policy to recognize the need to report all war reserves in the Army's Statement of Financial Position, regardless of their physical location or the automated system by which they are managed. Specifically, issue a policy stating that all ammunition war reserves reported through the Worldwide Ammunition Reporting System that are not reported through the Commodity Command System Standard System should be reported as assets on the Army's Statement of Financial Position.

DoD Response. Nonconcur. The FASAB currently is considering the issue of Capital Expenditures, such as war reserve ammunition and missiles. Until the FASAB has made a recommendation that has been accepted and promulgated by the Office of Management and Budget, it is the Department's policy that the Army FY 1993 Statement of Financial Position will reflect only those munitions maintained at wholesale supply activities and reported through the Army's Commodity Command Standard System. The FASAB is expected to issue a comprehensive set of all standards by March 1995.

B-2 Recommendation. Direct the Defense Finance and Accounting Service - Indianapolis Center to record the war reserve munitions in the Army's FY 1993 Statement of Financial Position as assets on the Non-Financial Resources - Other line. This will require an adjusting entry to increase the total by \$6.4 billion.

DoD Response. Nonconcur. As stated above, until the FASAB has made a recommendation that has been accepted and promulgated by the Office of Management and Budget, it is the Department's policy that the Army FY 1993 Statement of Financial Position will reflect only those munitions maintained at wholesale supply activities and reported through the Army's Commodity Command Standard System.

Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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