

**Audit**



**Report**

OFFICE OF THE INSPECTOR GENERAL

**REVENUE RECOGNITION POLICIES FOR THE ARMY  
DEFENSE BUSINESS OPERATIONS FUND**

Report No. 97-091

February 12, 1997

**Department of Defense**

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### **Acronyms**

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
IOC	Industrial Operations Command
OMB	Office of Management and Budget
SFFAS	Statement of Federal Financial Accounting Standards
SIFS	Standard Industrial Fund System



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



February 12, 1997

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)  
AUDITOR GENERAL OF THE ARMY**

**SUBJECT: Audit Report on Revenue Recognition Policies for the Army Defense  
Business Operations Fund (Report No. 97-091)**

We are providing this audit report for review and comment. We reviewed revenue recognition policies for the Army Defense Business Operations Fund as part of our audit of the revenue accounts in the FY 1996 Defense Business Operations Fund financial statements. We performed the audit in response to Chief Financial Officers Act of 1990 requirements for financial statement audits. This report is the fifth in a series of reports dealing with Defense Business Operations Fund revenue issues. We considered management comments on a draft of the report in preparing the final report.

DoD Directive 7650.3 requires that audit reports be resolved promptly. The Army comments to the draft report were responsive; however, the Under Secretary of Defense (Comptroller) comments were not. Therefore, we request that the Under Secretary of Defense (Comptroller) reconsider his position and provide additional comments by April 11, 1997.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David C. Funk, Audit Program Director, at (303) 676-7445 (DSN 926-7445) or Mr. Byron B. Harbert, Audit Project Manager, at (303) 676-7405 (DSN 926-7405). If management requests, we will provide a formal briefing on the audit results. See Appendix C for the report distribution. The audit team members are listed inside the back cover.

**Robert J. Lieberman  
Assistant Inspector General  
for Auditing**

## Office of the Inspector General, DoD

Report No. 97-091  
Project No. 5FD-2020.04

February 12, 1997

### Revenue Recognition Policies for the Army Defense Business Operations Fund

#### Executive Summary

**Introduction.** During our audit of the revenue accounts of the FY 1996 Defense Business Operations Fund financial statements, the Army Audit Agency notified us of Army plans to change the method used to recognize contract revenue in the Standard Industrial Fund System. We performed the revenue accounts audit to fulfill the requirements of the Chief Financial Officers Act of 1990 (Public Law 101-576, November 15, 1990) as amended by the Federal Financial Management Act of 1994 (Public Law 103-356), October 13, 1994.

This report is the fifth in a series of reports dealing with Defense Business Operations Fund revenue issues. The other reports dealt with the misclassification of an equity transfer as revenue, overstatement of revenues because of intrafund transactions not being appropriately eliminated, erroneous charges to the Distribution Depot business area for over-ocean transportation of materiel, and accounting for appropriated capital used. See Appendix B for details of those reports.

**Audit Objectives.** The overall objective of the revenue accounts audit was to determine whether revenues on the FY 1996 Defense Business Operations Fund consolidated financial statements are presented fairly in accordance with the "other comprehensive basis of accounting" described in Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Specifically, we determined the validity of revenues recognized for the Defense Business Operations Fund. During this portion of the audit, we reviewed the planned change to the method for recognizing contract revenue in the Standard Industrial Fund System. We did not review management controls over contract revenues because the issue addressed in this report pertains to DoD policy and not to operations. We will assess internal controls and compliance with laws and regulations applicable to those objectives in a future report.

**Audit Results.** The Army plans to update the Standard Industrial Fund System to meet DoD revenue recognition requirements that will be superseded by Office of Management and Budget Statement of Federal Financial Accounting Standards Number 7 on October 1, 1997. DoD 7000.14-R, "DoD Financial Management Regulation," requires revenue recognition procedures contradicting the new Office of Management and Budget standard. As a result, DoD will needlessly spend approximately \$45,000 to reconfigure the Standard Industrial Fund System to meet outdated requirements and a potential impediment to favorable financial statement audit opinions will not be addressed.

By implementing the recommendations made in this report, DoD can avoid unnecessarily spending \$45,000 and help to bring the methods used to recognize contract revenues into compliance with the new Federal standard.

**Summary of Recommendations.** We recommend that the Under Secretary of Defense (Comptroller) advise the Army Industrial Operations Command to suspend making the system change to implement the completed contract method of recognizing revenue until it has been determined how DoD will implement the Office of Management and Budget revenue recognition standard for contracts.

**Management Comments.** The Deputy Chief Financial Officer nonconcurred with the recommendation, stating that the current revenue recognition policy for the completed contract method conforms with Statement of Federal Financial Accounting Standards (SFFAS) Number 7.

We received unsolicited comments from the Principal Deputy Assistant Secretary of the Army (Financial Management and Comptroller). Although the comments were not required, the Principal Deputy Assistant Secretary of the Army (Financial Management and Comptroller) concurred with the recommendation and advised the Army Industrial Operations Command to suspend making the changes to the Standard Industrial Fund System. See Part I for a complete discussion of management comments and Part III for the complete text of management comments.

**Audit Response.** The Army comments and actions were responsive to the intent of our recommendation. The Deputy Chief Financial Officer comments were not responsive and this poses a DoD-wide policy issue. In our opinion, the position that the current DoD revenue recognition policy for using the completed contract method conforms with the requirements of SFFAS No. 7 is incorrect. Using the completed contract method for contracts that span fiscal years results in a difference, and the amount of the difference could be material. The failure to implement SFFAS No. 7, without regard to any other circumstances, could result in a qualified opinion or disclaimer of opinion, depending upon the materiality of the difference. We request that the Under Secretary of Defense (Comptroller) reconsider the comments on this matter by April 11, 1997 and provide additional comments in response to this final report.

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# **Part I - Audit Results**

### Audit Background

The Army Audit Agency notified us of Army plans to change the method used to recognize contract revenue in the Standard Industrial Fund System (SIFS) during our audit of "Revenue Accounts in the FY 1996 Financial Statements of the Defense Business Operations Fund (DBOF)." We performed the audit to meet the requirements of the Chief Financial Officers Act of 1990 (Public Law 101-576, November 15, 1990) as amended by the Federal Financial Management Act of 1994 (Public Law 103-356, October 13, 1994). The Chief Financial Officers Act requires DoD to prepare annual, audited financial statements for the preceding year and submit them to the Director, Office of Management and Budget (OMB). Those financial statements report the financial position and results of operations of DBOF components.

This report is the fifth in a series of reports dealing with revenue issues in DBOF. The other reports dealt with the misclassification of an equity transfer as revenue, overstatement of revenues because intrafund transactions were not being appropriately eliminated, erroneous charges to the Distribution Depot business area for over-ocean transportation of materiel, and accounting for appropriated capital used. See Appendix B for details of those reports.

**Defense Business Operations Fund.** DBOF, a revolving fund, was established on October 1, 1991, by the Secretary of Defense. The DBOF merged nine existing individual stock and industrial funds, along with five DoD commercial operations or business organizations previously funded with appropriated funds.

DBOF business areas receive their initial working capital through appropriations or resources transferred from existing appropriations of funds; they use those capital resources to finance the cost of goods and services. Customer orders generate resources to replenish working capital and permit continuing operations. In FY 1995, reported annual revenues for DBOF were \$76.6 billion.

In December 1996, the Under Secretary of Defense (Comptroller) announced that the DBOF would be broken out into several separate working capital funds. This realignment does not affect the matters discussed in this report.

**Army Depot Maintenance.** The Army Depot Maintenance portion of DBOF is divided into two business areas, Depot Maintenance-Ordnance and Depot Maintenance-Other. In FY 1995, these two business areas recognized revenues of \$2.5 billion.

The Depot Maintenance-Ordnance function encompasses ammunition management and related manufacturing activities. These activities support the materiel development, procurement, readiness, and management missions. Assigned functions include materiel readiness and logistics management including follow-on procurement, production, maintenance, engineering, and integrated logistics support management. Other functions include engineering in

support of production, industrial management, value engineering, configuration management, international logistics, tools and equipment engineering, product assurance, transportation, and traffic management for assigned systems and materiel. For FY 1995, the Depot Maintenance-Ordnance business area reported revenues of \$629 million.

The Depot Maintenance-Other function encompasses the depot maintenance and some minor depot supply operations performed by the Industrial Operations Command (IOC). Depot maintenance includes the overhaul, rebuild, conversion, renovation, modification, repair, inspection and test, manufacture, fabrication, and reclamation of materiel. Installations store, maintain, distribute, and demilitarize ammunition and perform base support operations. For FY 1995, the Depot Maintenance-Other business area reported revenues of \$1.8 billion.

## **Audit Objectives**

The overall revenue accounts audit objective was to determine whether revenues on the FY 1996 DBOF consolidated financial statements are presented fairly in accordance with the "other comprehensive basis of accounting" described in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Specifically, we determined the validity of revenues recognized for DBOF. For this portion of the audit, we reviewed the planned change to the method used to recognize contract revenue in SIFS. We did not review management controls over contract revenues because the issue addressed in this report pertains to DoD policy and not to operations. We will assess internal controls and compliance with laws and regulations applicable to those objectives in a future audit report. See Appendix A for a discussion of audit scope and methodology.

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## Army Depot Maintenance Revenue Recognition

The Army planned to change SIFS to meet current revenue recognition requirements contained in DoD 7000.14-R, "DoD Financial Management Regulation," Volume 11B, "Reimbursable Operations, Policy and Procedures--Defense Business Operations Fund," December 1994, though the current Army system partially complies with a new OMB accounting standard that DoD must implement by October 1, 1997. The current DoD policy for contracts estimated to cost less than \$1 million or to be completed in less than 12 months is not in accordance with the new OMB standard. The Army planned to change SIFS because the Defense Finance and Accounting Service (DFAS) determined that the Army revenue recognition method does not comply with DoD policy and should be changed. The determination by DFAS occurred before OMB had issued the new accounting standard. As a result, an estimated \$45,000 was to have been spent unnecessarily to change SIFS to support requirements that will become obsolete on October 1, 1997.

### Revenue Recognition Methods

When accounting for contract revenues, the timing of revenue recognition is determined by the revenue recognition method used. The primary methods used to compute contract revenues are completed contract and percentage-of-completion.

**Completed Contract Method.** The completed contract method of accounting for contract revenues defers recognition of all revenues and expenses associated with a contract until the contract is completed. If a contract is not started and completed in the same fiscal year, revenues, expenses, and results of operations for both fiscal years will be misstated.

**Percentage-of-Completion Method.** The percentage-of-completion method of accounting for contract revenues recognizes revenue incrementally over the life of the contract. This method uses a measure of progress to determine how much revenue will be recognized in each accounting period. The measure of progress used can be based on input measures or output measures. Input measures are made in relation to the costs or efforts devoted to a contract. These are generally based on a percentage of total costs incurred or on some measure of work performed. Output measures are made in terms of results achieved. These can include contract milestones reached, units produced, or value added. The percentage-of-completion method results in revenues being more accurately matched with the expenses used to generate those revenues.

## Federal Financial Accounting Standard

The OMB Statement of Federal Financial Accounting Standards (SFFAS) Number 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," May 1996, provides accounting standards for inflows of resources from revenue and other financing sources. SFFAS Number 7 provides the following standard for accounting for contract revenues:

When specific goods are made to order under a contract (either short- or long-term), or specific services are produced to order under a contract (either short- or long-term), revenue should be recognized in proportion to estimated total cost when goods and services are acquired to fulfill the contract.

This accounting treatment for revenue recognition is commonly referred to as the percentage-of-completion method. SFFAS Number 7 clarifies the requirements for using the percentage-of-completion method stating:

In some instances, however, there may be no material difference between the percentage-of-completion method and the completed contract method. This is especially likely for small or short-term contracts. In such instances, the completed contract method could be followed.

Federal Departments and Agencies are required to implement the accounting standards in SFFAS Number 7 for FY 1998. Earlier implementation is encouraged.

## DoD Financial Regulations

DoD 7000.14-R, Volume 11B, states that revenue and associated costs must be recognized in the same accounting period and that all DBOF business area activities must recognize revenue in the same manner. It directs Depot Maintenance organizations to recognize revenues based on the amount and duration of the project. For all projects with an estimated value less than \$1 million or a planned production cycle less than 12 months, the completed contract method of revenue recognition is required. For projects valued in excess of \$1 million and with a planned production cycle exceeding 12 months, the percentage-of-completion method of revenue recognition is required.

This policy differs from the revenue recognition requirements of SFFAS Number 7, which allows the use of the completed contract method only if it will not result in a material difference in the amount of revenue recognized. The DoD policy requiring that the completed contract method of revenue recognition be used for all contracts valued at less than \$1 million or with a planned production cycle of less than 12 months can result in a material difference in revenue recognition for those contracts that are not started and completed in the

## Army Depot Maintenance Revenue Recognition

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same fiscal year. For those contracts, the completed contract method does not recognize revenues and expenses in the first year of the contract, while the percentage-of-completion method recognizes revenues and expenses accrued as of the end of each fiscal year. The total amount of revenues and expenses not recognized by the completed contract method could be material, causing the financial statements to be materially misstated.

## Army Procedures

Army Depot Maintenance uses SIFS to account for revenues and expenses related to Depot Maintenance contracts. The SIFS currently uses the completed unit method, which represents a partial implementation of the percentage-of-completion method, for recognizing revenue from projects with estimated costs of less than \$1 million or planned production cycles of less than 12 months. Under this method, projects are divided into units. At the end of the reporting cycle, the number of units completed to date are identified. Revenues and expenses related to the completed units are recognized in the financial statements. This method, although not a full implementation of the percentage-of-completion method, provides more accurate revenue and expense information than the completed contract method.

**DFAS Notification.** In May 1995, the Chief, Financial Systems Division, Army Systems Integration and Management Activity, sent a memorandum to DFAS stating that the SIFS method of revenue recognition complied with generally accepted accounting principles. In October 1995, the Deputy Director of Business Funds, DFAS, replied to the Army memorandum stating that the SIFS method, while conforming to generally accepted accounting principles, did not conform with the DoD policy. The reply also stated that the current SIFS procedure should be changed to achieve a standard practice throughout DoD. Accordingly, the Army plans to change SIFS to implement the DoD policy regarding the completed contract method. The Army Materiel Command Systems Integration and Management Activity has estimated that this change will cost \$45,000. The requested system change has not yet been accomplished.

**Request for Waiver.** In November 1996, the Army IOC requested that DFAS grant a waiver from the DoD requirement that the completed contract method of revenue recognition be used for all contracts with an estimated value of less than \$1 million or a planned production cycle of less than 12 months. The waiver request states that the requirement to use the completed contract method violates the SFFAS Number 7 requirement that the percentage-of-completion method be used for all contracts, except when there is no material difference between the two methods. The waiver request states that using the completed contract method for all contracts under \$1 million or less than 12 months would result in revenue reported on annual financial statements that would be materially different than the revenue that would be recognized under the percentage-of-completion method. The DFAS has not yet replied to the request for waiver.

**DoD Comptroller Plans.** We discussed the revenue recognition standard with the Director for Accounting Policy, Office of the Under Secretary of Defense (Comptroller), who informed us that his office is reviewing the DoD policy for recognizing revenue on short-term contracts with regard to the new standard. He indicated that the standard leaves room for interpretation and that he will determine later whether the DoD policy should be changed.

**Inspector General, DoD, Position.** The DoD policy should be changed to meet the new accounting standard for recognizing revenue on contracts required by SFFAS Number 7. The current DoD policy could result in material differences from the new standard and thereby cause financial statements to be materially misstated.

## Recommendations, Management Comments, and Audit Response

We recommend that the Under Secretary of Defense (Comptroller) advise the Army Industrial Operations Command to suspend making the system change to implement the completed contract method in accordance with current DoD policy until a determination is made regarding how DoD will implement the revenue recognition standard for contracts required by Office of Management and Budget "Statement of Federal Financial Accounting Standards Number 7," June 1996.

**Management Comments.** The Deputy Chief Financial Officer, commenting for the Under Secretary of Defense (Comptroller), nonconcur with the recommendation, stating that SFFAS Number 7 allows for the use of the completed contract method if no material difference exists between the two methods. The Deputy Chief Financial Officer believes that the current revenue recognition policy for the completed contract method, as reflected in Chapter 61 of the DoD Financial Management Regulation, conforms with SFFAS Number 7. The Deputy Chief Financial Officer further stated that the audit report does not provide information or compelling evidence proving that the difference in the total amount of revenues and expenses recognized under the two methods is material.

**Audit Response.** The Deputy Chief Financial Officer comments are not responsive. The statement that the current DoD revenue recognition policy for using the completed contract method conforms with the requirements of SFFAS No. 7 is incorrect. SFFAS No. 7 requires that the percentage-of-completion method be used for all contracts unless no material difference would result from using the completed contract method. The DoD policy requires the completed contract method for contracts with an estimated completion time of up to 12 months. Many of these contracts are begun in one fiscal year and completed in another. Under the completed contract method, revenues are not recognized at the end of the fiscal year for projects that are not completed. As a result, revenues existing at the end of the fiscal are not recognized until the following fiscal year. Using the completed contract method for contracts that span fiscal

## **Army Depot Maintenance Revenue Recognition**

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years results in a difference, and the amount of the difference could be material. The reason for using the percentage-of-completion method is to recognize those revenues that arise in the applicable fiscal year.

The Deputy Chief Financial Officer's assumption that no material difference exists between the two revenue recognition methods may be incorrect. The only way to determine whether the two methods produce a material difference is to account for revenues using both methods and compare the results. The Deputy Chief Financial Officer should determine that the difference would not be material before making a policy decision to continue to use the completed contract method. Without comparison information, there can be no assurance that DoD is accounting for revenues in accordance with SFFAS No. 7 and in a comparable manner with other Federal departments and agencies. Accordingly, auditors may not be able to satisfy themselves in future financial statement audits that revenue account balances are fairly presented. This circumstance alone could result in a qualified opinion or disclaimer of opinion, depending upon the materiality of the difference, in continuing with the current DoD policy.

We request the Under Secretary of Defense (Comptroller) reconsider the comments and provide additional comments in response to this final report.

**Other Management Comments.** Although not required to, the Principal Deputy Assistant Secretary of the Army (Financial Management and Comptroller) also provided comments to a draft of this report. The Principal Deputy Assistant Secretary of the Army (Financial Management and Comptroller) concurred with the finding and recommendation and has advised the Army Industrial Operations Command to suspend making the system changes.

## **Part II - Additional Information**

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## **Appendix A. Scope and Methodology**

### **Scope**

As part of our financial-related audit of "Revenue Accounts in the FY 1996 Financial Statements of the Defense Business Operations Fund," we reviewed the planned change to the method used to recognize contract revenue in SIFS. This review included evaluating the DoD policy for recognizing contract revenue.

### **Methodology**

We performed our review of the planned change to SIFS from October 1996 through December 1996 in accordance with standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. We reviewed information provided by the Under Secretary of Defense (Comptroller), the Army Audit Agency, and the Army IOC. We did not use computer-processed data or statistical sampling procedures for this review. We did not review management controls over contract revenues because the issue addressed in this report pertains to DoD policy and not to operations.

### **Organizations and Individuals Visited or Contacted**

**Contacts During the Audit.** We visited or contacted individuals and organizations within the DoD. Further details are available on request.

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## **Appendix B. Prior Audits and Other Reviews**

### **Inspector General, Department of Defense**

The Inspector General, Department of Defense, previously issued four reports on issues identified during the audit of the revenue accounts in the FY 1996 DBOF financial statements:

**Inspector General, DoD, Report No. 97-081, "Appropriated Capital Used in the FY 1995 Defense Business Operations Fund Financial Statements," January 27, 1997.** This report states that the FY 1995 DBOF consolidated financial statements did not correctly report the appropriated funds used by DBOF for commissary operations. As a result, the FY 1995 Defense Business Operations Fund Consolidated Statement of Operations and Changes in Net Position understated revenues and financing sources by \$940 million and overstated the shortage of revenues and financing sources over expenses by a like amount.

**Inspector General, DoD, Report No. 97-040, "Distribution Depot Over-Ocean Second-Destination Transportation Costs," December 10, 1996.** This report states that transportation costs applicable to other DoD organizations were erroneously charged to the Distribution Depot business area of the Defense Business Operations Fund. Our review of three summary bills of 104,878 shipments, totaling \$26.8 million, showed that \$10.5 million (39 percent) was erroneously charged to the Distribution Depot business area. After our review, a management consulting firm hired by DLA found an additional \$41.8 million (27 percent) of \$155.7 million paid from April 1995 through March 1996 was not applicable to the Distribution Depot business area. As a result, the Distribution Depot business area paid for material amounts of transportation costs that should have been paid by other DoD organizations. In FY 1995, the Distribution Depot business area lost \$102 million in over-ocean second-destination transportation costs; this loss was caused partly by erroneous bills. Management actions planned were responsive to the recommendations.

**Inspector General, DoD, Report No. 96-198, "Defense Logistics Agency Revenue Eliminations," July 22, 1996.** This report states that when the Defense Logistics Agency (DLA) made sales to other organizations that are part of DBOF, revenues from these sales were not eliminated from the amount reported in the FY 1995 financial statements, as required by Under Secretary of Defense (Comptroller) guidance. Consequently, \$13.3 billion in revenue reported by DLA in the FY 1995 DBOF consolidated financial statements was overstated by \$8.4 billion (63 percent). Revenue was also overstated by \$0.6 billion in the DLA financial statements. Management actions planned were responsive to the recommendations.

## Appendix B. Prior Audits and Other Reviews

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**Inspector General, DoD, Report No. 96-160, "Defense Business Operations Fund Equity Transfer--Defense Commissary Agency," June 13, 1996.** This report states that at the direction of an official in the Office of the Under Secretary of Defense (Comptroller), the Defense Commissary Agency erroneously reported a \$251.6 million transfer of equity from the DLA segment of DBOF as revenue in the FY 1995 financial statements. As a result, revenues and net results of operations were overstated by \$251.6 million in the FY 1995 DBOF consolidated financial statements. The Deputy Chief Financial Officer concurred with the finding and recommendations.

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## **Appendix C. Report Distribution**

### **Office of the Secretary of Defense**

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Director, Defense Logistics Studies Information Exchange  
Under Secretary of Defense (Comptroller)  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Director, Accounting Policy  
Assistant to the Secretary of Defense (Public Affairs)

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

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

### **Department of the Air Force**

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Director (Audit Liaison and Follow Up)  
Auditor General, Department of the Air Force

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Director, Defense Finance and Accounting Service  
Director, Defense Logistics Agency  
Director, National Security Agency  
Inspector General, National Security Agency  
Inspector General, Defense Intelligence Agency

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General Accounting Office

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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



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



JAN 10 1997

MEMORANDUM FOR ACTING DIRECTOR, FINANCE AND ACCOUNTING  
DIRECTORATE, OFFICE OF THE DEPARTMENT OF  
DEFENSE INSPECTOR GENERAL

SUBJECT: Quick Reaction Report on Revenue Recognition Policies for the Army Defense  
Business Operations Fund (Project No. 5FD-2020.04)

This is in response to your memorandum dated, December 24, 1996, requesting comments on subject report.

The subject report states that the current Department of Defense (DoD) policy for contracts estimated to cost less than \$1 million, or to be completed in less than 12-months, is not in accordance with Office of Management and Budget Statement of Federal Financial Accounting Standards (SFFAS) Number 7, "Accounting for Revenue and Other Financing Sources for Reconciling Budgetary and Financial Accounting," May 1996. Therefore, the Department of Defense Inspector General (DoDIG) concludes that the DoD policy will have to be changed to meet the new accounting standard for recognizing revenue on contracts required by SFFAS Number 7. Accordingly, the report recommends that the Under Secretary of Defense (Comptroller) advise the Army Industrial Operations Command, and any other affected organizations, to suspend making system changes to implement the completed contract method until it has been determined how the DoD will implement revenue recognition standards for contracts.

The SFFAS Number 7 states that there may be no material difference between the percentage of completion method and the completed contract method. In such instances, the completed contract method of revenue recognition is acceptable. This office believes that the current revenue recognition policy for the completed contract method, as reflected in Chapter 61 of the DoD Financial Management Regulation, conforms with the SFFAS Number 7. Accordingly, this office disagrees that the DoD revenue recognition policy will have to be changed to meet the requirements of SFFAS Number 7.

The DoDIG has not provided information, nor compelling evidence, to substantiate that the total amount of revenues and expenses that might be recognized by the percentage of completion contract method, but not recognized by the use of the completed contract method is material, or will cause financial statements to be materially misstated. Without such data, this office does not concur that it should advise the Army Industrial Operations Command to suspend

## Under Secretary of Defense (Comptroller) Comments

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making systems changes to implement the completed contract method, thereby failing to comply with the DoD Financial Management Regulation.

Mr. John Glover is my staff contact for this matter. He may be reached at 697-0537.



Alvin Tucker  
Deputy Chief Financial Officer

# Department of the Army Comments



REPLY TO  
ATTENTION OF

DEPARTMENT OF THE ARMY  
OFFICE OF THE ASSISTANT SECRETARY  
109 ARMY PENTAGON  
WASHINGTON, DC 20310-0109

13 JAN 1997



MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE (AUDITING)

SUBJECT: Quick Reaction Report on Revenue Recognition Policies for the Army Defense Business  
Operating Fund (Project 5FD-2020.04)

We have completed our review of subject audit report and have attached our comments to your recommendations.

Should you require any additional information concerning our comments, my point of contact is Mr. Anderson. He may be reached at (703) 697-5706 or DSN 227-5706.

Neil R. Ginnetti  
Principal Deputy Assistant Secretary of the Army  
(Financial Management and Comptroller)

Attachment

OFFICE OF THE INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE

DRAFT OF A PROPOSED AUDIT REPORT ON ARMY DEFENSE BUSINESS  
OPERATIONS FUND'S REVENUE RECOGNITION POLICIES  
PROJECT NO. 5FD-2020.04

For the Assistant Secretary of the Army  
(Financial Management and Comptroller)

**Finding:** After DFAS determined that the Army Revenue Recognition method did not comply with DoD Financial Management Regulation (FMR) 7000.14R, the Army planned to update the Standard Industrial Fund System at a cost of \$45,000. However, OSD must implement a new Office of Management and Budget Federal Financial Accounting Standard (Number 7) by October 1, 1997. Because of this requirement, it is inappropriate to make the previously planned system change.

- The Army Industrial Operations Command is in the process of preparing a request for Waiver to Financial Management Regulation (FMR) 7000.14R to prevent spending \$45,000 for a system change that will become obsolete by 1 Oct 97.

- If Army is forced to comply with FMR 7000.14R, revenue recognized will not be accurate and could result in a material difference in the amount of revenue recognized.

**Recommendation:** The Inspector General, Department of Defense, recommends that the Under Secretary of Defense (Comptroller) advise the Army Industrial Operations Command to suspend making the system change to implement the completed contract method of recognizing revenue until it has been determined in what manner DoD will implement the Office of Management and Budget (OMB) revenue recognition standard for contracts.

**Action Taken:** Concur. However, we have taken action to advise the Army Industrial Operations Command to suspend making these system changes and will inform the Under Secretary of Defense (Comptroller) of this action.

## **Audit 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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