Audit Report

OFFICE OF THE INSPECTOR GENERAL

REPORTING OF CONTRACT HOLDBACKS ON THE DOD FINANCIAL STATEMENTS

Report No. 98-022 November 17, 1997

Department of Defense

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Acronyms

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

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

November 17, 1997

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Audit Report on Reporting of Contract Holdbacks on the DoD Financial Statements (Report No. 98-022)

We are providing this audit report for review and comments. We performed this audit in response to the Chief Financial Officers Act of 1990 and the Federal Financial Management Act of 1994.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Because the Under Secretary of Defense (Comptroller) did not comment on a draft of this report, we request comments on the final report by January 05, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. James L. Kornides, Audit Program Director, (614) 751-1400, extension 11 (JKornides@DODIG.OSD.MIL), or Mr. Stuart D. Dunnett, Audit Project Manager, (614) 751-1400, extension 14 (SDunnett@DODIG.OSD.MIL). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. 98-022 **November 17, 1997**
Project No. 6FJ-2010.00

Reporting of Contract Holdbacks on the DoD Financial Statements

Executive Summary

Introduction. This report resulted from our DoD-wide audit of DoD progress payment procedures. The Military Department audit organizations assisted in obtaining the information included in the report. Progress payments are a means of providing contract financing for Work-in-Process expenditures with long lead times, often required on Government contracts. Progress payments alleviate undue strain on a contractor's cash flow by financing a specified percentage of contract costs incurred as work progresses.

Contract holdbacks are unreimbursed contractor costs not funded through progress payments. The amounts are held back, rather than paid as progress payments, to provide assurance that the work will be completed as required by the contract. Contract holdbacks represent Accounts Payable because the Government has incurred a liability for the amount held back.

Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, requires that Federal agencies report contractors' work progress, including the liability for funds held back from progress payments, in the financial statements. The Military Departments and the Defense Logistics Agency (DLA) reported unliquidated progress payments for FY 1996 of about $29.7 billion. Contract holdbacks of about $2.3 billion were reported on the financial statements.

Audit Objectives. The primary audit objective was to determine whether progress payments made to Defense contractors were accurately reflected in DoD accounting records. This part of the audit determined whether contract holdbacks were accurately recorded on the DoD financial statements.

Audit Results. The Military Department and DLA financial statements did not accurately report payments withheld from contractors in FY 1996 and the work associated with the payments. The Military Departments and the DLA recognized about $2.3 billion of holdbacks in Accounts Payable in the financial statements. However, we estimated that an additional $4.9 billion of funds was withheld but not reported. Additionally, the $7.2 billion of work for which the payments were withheld was not recognized as an asset on the statements of financial position. As a result, assets were understated by $7.2 billion and liabilities were understated by $4.9 billion on the FY 1996 financial statements of the Military Department General Fund and the DLA Defense Business Operations Fund. This material understatement affected the overall reliability of the statements. Implementing the recommendations in this report will improve the accuracy of contractors' work progress reported in the financial statements.

Recommendations. We recommend that the Under Secretary of Defense (Comptroller), require the Director, Defense Finance and Accounting Service (DFAS), to comply with the reporting requirements in the "DoD Guidance for Form and Content of Financial Statements for FY 1996 Financial Activity," October 1996, for Accounts Payable; revise the "DoD Financial Management Regulation," DoD 7000.14-R, volume 4, January 1995, to give specific accounting guidance for reporting contractors' unpaid work progress related to progress payment billings; and direct DFAS, the Military Departments, and DLA to calculate contract holdbacks based on unliquidated progress payment balances until the accrued expenditure report produces reliable data.

Management Comments. We issued a draft of this report on July 14, 1997. The Under Secretary of Defense (Comptroller) did not comment on the draft report. Therefore, we request written comments on the final report by January 05, 1998.

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Part I - Audit Results

Audit Background

This report resulted from our DoD-wide audit of DoD progress payment procedures. The Military Department audit organizations assisted us in obtaining information. Progress payments are a means of providing contract financing for Work-in-Process expenditures with long lead times, often required on Government contracts. Progress payments alleviate undue strain on a contractor's cash flow by financing a specified percentage of contract costs incurred as work progresses.

Contract holdbacks represent the amount of unreimbursed contractor costs not funded through progress payments. The amounts are held back, rather than paid as progress payments, to provide assurance that the work will be completed as required by the contract. Contract holdbacks represent Accounts Payable because the Government has incurred a liability for the amount held back.

Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, requires that Federal agencies report contractors' work progress, including the liability for funds held back, in the financial statements. The Military Departments and the Defense Logistics Agency (DLA) reported unliquidated progress payments for FY 1996 of about $29.7 billion. The reliability of the reported $29.7 billion in unliquidated progress payments will be addressed in a subsequent report. Contract holdbacks of about $2.3 billion were reported on the financial statements.

Audit Objectives

The primary audit objective was to determine whether progress payments made to Defense contractors were accurately reflected in DoD accounting records. This part of the audit determined whether contract holdbacks were accurately recorded on the DoD financial statements.

See Appendix A for a discussion of the audit scope and methodology and Appendix B for a summary of prior audit coverage related to the audit objective.

Accounting for Contract Holdbacks

The Military Departments and DLA did not accurately recognize, in DoD accounting records or financial statements, contract holdbacks for work performed by Defense contractors. Additionally, the work progress for which the funds were withheld was not disclosed as an asset in the accounting records or financial statements. Specifically, the Military Departments and DLA did not properly recognize either:

o liabilities for contract holdbacks that represented future and certain cash outlays owed to Defense contractors for unpaid costs on DoD contracts; or

o assets for the amount of progress made on the contract that was not funded through progress payments.

These conditions occurred because the Military Departments and DLA did not follow the "DoD Guidance on Form and Content of Financial Statements for FY 1996 Financial Activity" (DoD Form and Content Guidance), October 1996; DoD 7000.14-R, the "DoD Financial Management Regulation," volume 4, June 1995, was unclear; and the accrued expenditure report prepared by the Defense Finance and Accounting Service (DFAS) Columbus Center was inaccurate.

As a result, contract holdbacks, an Accounts Payable, and the asset accounts used to report Defense contractors' work progress were materially understated on the FY 1996 DoD financial statements. Based on reported balances of progress payments, we estimated that about $4.9 billion in Accounts Payable (liabilities) and about $7.2 billion in work progress (assets) on DoD contracts were not accurately reflected on the FY 1996 Statements of Financial Position of the Military Department General Fund and the DLA Defense Business Operations Fund (DBOF).

Progress Payments and Holdbacks

Progress payments finance various operating expenses, such as research and development, raw materials, and special tooling and test equipment, that Defense contractors incur. Progress payments are used instead of construction loans. DoD contracts contain progress payment clauses that authorize Defense contractors to receive payment of expenses incurred before an item is delivered. The Federal Acquisition Regulation part 32.503-5, "Administration of Progress Payments," requires that progress payments be supported by the fair value of the work accomplished by the Defense contractor.

Progress Payment Calculations. The Federal Acquisition Regulation part 32.501-1, "Progress Payment Rates," allows administrative contracting officers to approve up to 80 percent of a contractor's cumulative costs for progress payments. The remaining 20 percent is held back as an incentive to ensure proper completion of the contract.

In FY 1996, contractors billed DoD for an average of 79 percent of the cost of the work progress. Contract holdbacks represented the remaining amount of unpaid Defense contractor costs not funded through progress payments, an average of 21 percent in FY 1996.

Liquidating Progress Payments. Contractors provide cost data through progress payment invoices that summarize the total costs incurred on a contract on a specified date. As goods are delivered, progress payments are liquidated based on the rate established in the contract. At that time, DoD pays the remaining amount owed (the contract holdback) minus the prior progress payments.

Accounting Guidance for Contractor Holdbacks and Work Progress

The DoD Form and Content Guidance and DoD 7000.14-R provide guidance for reporting progress made on DoD contracts and for reporting contract holdbacks as Accounts Payable.

The DoD Form and Content Guidance requires that progress made on DoD contracts be reported either as Progress Payments Made to Others (summarized in the Advances and Prepayments account) or Work-in-Process. DoD 7000.14-R requires journal entries for recording contract holdbacks and the related asset amount for contractor work progress.

Recognizing and Reporting Contract Holdbacks

The Military Departments and DLA did not properly recognize the funds held back on progress made by Defense contractors. The contract holdbacks represented future, certain cash outlays owed to Defense contractors for unreimbursed costs on DoD contracts. In addition, the contractors' progress for which the funds were withheld was not disclosed as an asset in accounting records or financial statements.

These problems occurred because the Military Departments and DLA did not follow the DoD Form and Content Guidance for financial statement reporting, and because DoD 7000.14-R gave vague and conflicting guidance on reporting contract holdbacks. In addition to these problems, recordkeeping for contract holdbacks was inaccurate.

Contract Holdbacks Included in the Financial Statements

Military Department and DLA Financial Statements. The Navy and the Air Force included some year-end information on contract holdbacks on the FY 1996 Statements of Financial Position of the General Fund. However, the Army and DLA did not include any data from the accrued expenditure report in their FY 1996 financial statements.

Navy and Air Force. The Navy and the Air Force FY 1996 Statements of Financial Position included only debit balances from the FY 1996 accrued expenditure report provided by the DFAS Columbus Center. Specifically, using only the debit amounts for their appropriations, the Navy and the Air Force posted Accounts Payable entries of $1.2 billion and $1.1 billion, respectively.

Based on our discussions with DFAS and work completed by the Naval Audit Service and the Air Force Audit Agency, DFAS did not make a corresponding debit entry to the Progress Payments Made to Others account or any other asset account to offset the $2.3 billion of Accounts Payable reported by the Navy and the Air Force. Instead, the Navy and the Air Force posted a debit entry to a non-operating expense account.

According to the DoD Form and Content Guidance, the Navy and the Air Force should have used the accrued expenditure report to calculate the total amount of Defense contractors' work progress to be recorded as Accounts Payable. They also should have made appropriate entries to the Progress Payments Made to Others account to reflect the portion of work that had occurred but remained unpaid as of September 30, 1996.

Army and DLA. The Army and DLA did not report any Accounts Payable for contract holdbacks or an asset for contractor work progress based on accrued expenditure data from the DFAS Columbus Center. In the footnotes to the Army FY 1996 General Fund financial statements, the Army reported that Accounts Payable were understated for contractor services provided but not yet paid. The Army stated that a reasonable estimate was unavailable because current contractor payment systems did not provide accrual accounting information. However, we concluded that a reasonable estimate for Army contract holdbacks was available, based on the $2.47 billion balance of unliquidated progress payments as of September 30, 1996.

Adherence to DoD Guidance

The DoD Form and Content Guidance, the Federal Accounting Standards Advisory Board (FASAB), and OMB require accounting entries to reflect the total amount of progress made on DoD contracts. However, the Military Departments and DLA did not adhere to the DoD Form and Content Guidance published by the Under Secretary of Defense (Comptroller) for presenting assets and liabilities on the financial statements. To ensure consistent and accurate financial reporting, the Military Departments and DLA are required to conform to the FASAB and OMB guidance.

Adequacy of DoD Guidance

DoD 7000.14-R did not clearly indicate the proper accounting treatment of progress made on DoD contracts and conflicted with the DoD Form and Content Guidance. In general, DoD financial personnel stated that DoD 7000.14-R did not offer clear guidance on the proper accounting treatment of contract holdbacks or the associated asset for contractor work progress.

DoD 7000.14-R provided a method of recording Defense contractors' progress payment invoices in the DoD accounting records, and that method captured the liabilities and assets associated with Defense contractors' work progress. However, the guidance in DoD 7000.14-R was not clear on the treatment of contract holdbacks.

DoD 7000.14-R states that the Contract Holdback account shall include progress payment invoices. However, DoD 7000.14-R does not clearly state that the Contract Holdback account should include the unpaid portion of Defense contractor costs incurred.

Conflicts in DoD Guidance. DoD 7000.14-R contradicted the DoD Form and Content Guidance regarding the reporting of assets for the unpaid work progress. The DoD Form and Content Guidance required that unpaid work progress on DoD contracts be reported as either Progress Payments Made to Others or Work-in-Process. However, DoD 7000.14-R allowed the use of the Construction-in-Progress account to record the holdback, but did not include a debit entry to the Progress Payments Made to Others account. Because DoD 7000.14-R did not agree with the DoD Form and Content Guidance, it was understandable that DoD personnel did not consistently record the contract holdbacks as Work-in-Process assets. DoD 7000.14-R should be revised to conform to the DoD Form and Content Guidance.

Reliability of Accrued Expenditure Report

In addition to the conflicting guidance, the accrued expenditure report, maintained at the DFAS Columbus Center for tracking contract holdbacks and associated work progress, was inaccurate.

Accrued Expenditure Report. The accrued expenditure report is a product of the Mechanization of Contract Administrative Services contract payment system maintained at the DFAS Columbus Center. The report was intended to provide the total dollar amount that would be needed to liquidate the DoD liability to contractors. The report provides Accounts Payable information at the appropriation level, based on three subsystems in the Mechanization of Contract Administration Services system.

In April 1993, the DFAS Columbus Center reported inaccuracies in the accrued expenditure report and stated that the cause was a systemic weakness. The systemic problem caused the processing of multiple Accounts Payable transactions. As a result, although amounts reported for unpaid work done by Defense contractors are normally debits, some of these amounts were reported as credits. This liability, as calculated by the DFAS Columbus Center, should be 21 percent of the unliquidated amount of progress payments made to Defense contractors.

Personnel at the DFAS Columbus Center recognize that a systemic problem exists and are testing changes to the Mechanization of Contract Administration Services system.

Contract Holdback Balances. We examined the balances in the accrued expenditure report in an attempt to determine the balance of the DoD contract holdbacks. Although the data were unreliable, the report provided information on about $2.3 billion of holdbacks. Based on unliquidated progress payment balances in FY 1996, we estimated that $7.2 billion in contract holdbacks was outstanding for FY 1996.

Although the report gave inaccurate balances for work progress made by Defense contractors, the Navy and the Air Force included data from the report in their FY 1996 Statements of Financial Position. The Army and DLA did not report accrued expenditure data for their appropriations because the data were unreliable.

Effect on Financial Statements

Contract holdbacks, as an Accounts Payable and as the asset accounts used to report contractors' work progress, were materially understated on the FY 1996 Statements of Financial Position of the DoD General Fund and the DLA DBOF. Based on reported progress payment balances of $29.7 billion, we estimated that $4.9 billion in Accounts Payable (liabilities) and $7.2 billion in contractor work

progress (assets) made on DoD contracts was not accurately reflected on the FY 1996 Statements of Financial Position of the Military Department General Fund and the DLA DBOF.

The $2.3 billion difference in the understatements of assets and liabilities occurred because the Navy and the Air Force posted an Accounts Payable without an offsetting asset entry, using data from the accrued expenditure report in the FY 1996 General Fund financial statements. For further details on the methodology used to obtain the estimate, see Appendix A.

Summary

Because of inadequate compliance with the DoD Form and Content Guidance, contradictory accounting policies, and an unreliable accounting report prepared by the DFAS Columbus Center, accounting entries for contract holdbacks were inaccurate. As a result, about $4.9 billion in Accounts Payable (liabilities) and about $7.2 billion in Defense contractors' unpaid work progress (assets) were not accurately shown on the FY 1996 DoD financial statements.

Other Matters of Interest

A recently issued Inspector General (IG), DoD, report recommended that DoD clarify accounting guidance for reporting progress payments. The report stated that progress payments were not consistently presented in the DoD financial statements and recommended changes to the DoD Form and Content Guidance. The report did not specifically address the reporting of contract holdbacks on the DoD financial statements.

Action Recommended by the IG, DoD. IG, DoD, Report No. 97-100, "Asset Presentation on Military Department General Fund Financial Statements," February 25, 1997, recommended that the Under Secretary of Defense (Comptroller) coordinate with the FASAB and OMB to revise the requirements in the DoD Form and Content Guidance for the presentation of progress payments. The report concluded that progress payments should be presented as Property, Plant, and Equipment-Construction-in-Progress and not as Advances and Prepayments or Work-in-Process. The Under Secretary of Defense (Comptroller) nonconcurred with the recommendation. The issue is currently in mediation. Until this issue is resolved, we are not making an additional recommendation related to the asset entry for progress payments or Defense contractors' work progress related to contract holdbacks.

Recommendations for Corrective Action

We recommend that the Under Secretary of Defense (Comptroller):

1. Require the Director, Defense Finance and Accounting Service, to comply with requirements in the the "DoD Guidance for Form and Content of Financial Statements for FY 1996 Financial Activity," October 1996, for reporting Accounts Payable on the financial statements.

2. Revise DoD 7000.14-R, the "DoD Financial Management Regulation," volume 4, January 1995, to give specific accounting guidance for reporting the liability and asset resulting from unpaid contractor work progress related to progress payment billings.

3. Direct the Defense Finance and Accounting Service, the Military Departments, and the Defense Logistics Agency to calculate contract holdbacks based on unliquidated progress payment balances until the accrued expenditure report produces reliable data. The accounts should include both a liability and asset entry to accurately reflect the progress made on DoD contracts.

Management Comments

The Under Secretary of Defense (Comptroller) did not respond to the draft of this report. Therefore, we request that the Under Secretary of Defense (Comptroller) provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope

The audit was performed by the IG, DoD, and the Military Department audit organizations. We reviewed the FY 1996 DoD General Fund and DLA DBOF financial statements to determine whether contract holdbacks and the offsetting work progress asset were presented in accordance with FASAB, OMB, and DoD guidance. The DoD Form and Content Guidance requires that the Military Departments and DLA report Defense contractors' unpaid work progress on the financial statements. In FY 1996, progress payments represented an average 79 percent of the total work done on DoD contracts.

During FY 1996, the DFAS Columbus Center disbursed $14 billion in progress payments to DoD contractors. As of September 30, 1996, the Military Departments and DLA reported $29.7 billion in unliquidated progress payments made to Defense contractors.

Methodology

Audit Period and Standards. This financial-related audit was conducted from November 1996 through June 1997. The audit was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD. Audit results are based on progress payment balances as of September 30, 1996, as reported by the Military Departments and DLA. We did not use statistical sampling techniques.

Use of Computer-Processed Data. We relied on computer-processed data, but we did not test the reliability of the data because we determined whether the Military Departments and DLA appropriately reported contract holdback amounts in accordance with FASAB, OMB, and DoD policy. Not establishing the reliability of the financial data did not materially affect the results of our audit.

Audit Estimate. To estimate the contract holdback balances for the Military Departments and DLA, we used an unliquidated progress payment balance of $29.7 billion, as reported in the DoD financial statements, and average rates of progress payment billings from the Army Audit Agency and the DFAS Columbus Center. We used unliquidated DoD progress payment balances of $2.5 billion for the Army, $19.9 billion for the Navy, $7 billion for the Air Force, and $199.7 million for DLA. To estimate the contract holdback amount, we used average rates of progress payment billings of 83.4 percent for the Army and 79 percent for the Navy, the Air Force, and DLA. To calculate

the progress payment holdbacks, we divided unliquidated progress payments by the average progress payment rate to obtain the contractor invoice amount. We then subtracted the unliquidated progress payments from the invoice amount.

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

Management Control Program

The management control program and the presentation of progress payments on the DoD financial statements will be addressed in the overall report on progress payments.

Appendix B. Summary of Prior Coverage

A recent IG, DoD, audit report addressed the accounting policy related to progress payments. In addition, the Army and Air Force Audit Agencies have issued draft reports that discuss the financial statement reporting of progress payment (contract) holdbacks. The Naval Audit Service did not address contract holdbacks in its audit of the FY 1996 General Fund.

IG, DoD, Report No. 97-100, "Asset Presentation on Military Department General Fund Financial Statements," February 27, 1997. This report stated that the DFAS Centers incorrectly and inconsistently presented assets on the FYs 1994 and 1995 Army and Air Force General Fund Financial Statements. The DFAS Centers incorrectly and inconsistently identified at least $31.3 billion of war reserves for the Army and an additional but unquantified amount for the Air Force, and about $10.5 billion of progress payments. The report recommended that the Under Secretary of Defense (Comptroller) clarify accounting guidance for presenting war reserves and progress payments on the financial statements. Management nonconcurred with the recommendation, and the report is now in mediation.

Army Audit Agency Report No. AA 98-17, "Financial Reporting of Progress Payments," November 14, 1997. This report stated that contract holdbacks were materially understated, progress payments were not consistently presented in the accounting records, and disbursements for progress payments made by the DFAS Columbus Center were not always matched with the correct obligations in the accounting records. The report recommended that the DFAS Indianapolis Center modify Army accounting systems to provide for the recording of contract holdbacks, direct accounting offices to use actual progress payment rates when calculating contract holdbacks, and review trial balances to ensure compliance with the recommended policy. Headquarters, DFAS, nonconcurred with the recommendations on reporting and calculating contract holdbacks, stating that the report inappropriately tied contract holdbacks to progress payments. DFAS management agreed that reviewing trial balances would be an appropriate validation check if a direct relationship existed between contract holdbacks and progress payments.

Air Force Audit Agency Project No. 96053006, "Weapon System Progress Payments, Fiscal Year 1996 Air Force Consolidated Financial Statements," July 3, 1997. This report stated that the Air Force Audit Agency was unable to determine the accuracy of the FY 1996 balance for weapon system progress payments. The Air Force Audit Agency identified $4.5 billion of undisclosed progress payments, and holdbacks of progress payments were understated by about $650 million. The report recommended that the DFAS Denver Center provide accounting offices with guidance on reporting unmatched progress payment transactions and on reporting unliquidated balances of progress payments and recoupments recorded in canceled appropriations at fiscal year-end. The report also recommended that the DFAS Denver Center disclose the potential impact of unmatched transactions at year-end in

the footnotes to the financial statements, and make departmental adjustments as necessary to accurately report progress payment balances in asset and liability accounts. DFAS concurred with the recommendations.

Appendix C. Report Distribution

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