Audit Report

OFFICE OF THE INSPECTOR GENERAL

CONTROLS OVER PRESENTING EXPENSE ACCOUNT LINE ITEMS ON THE FY 1996 STATEMENT OF OPERATIONS FOR THE AIR FORCE SUPPLY MANAGEMENT BUSINESS AREA

Report No. 98-056

January 27, 1998

Department of Defense

Additional Copies

To obtain additional copies of this audit report, contact the Secondary Reports Distribution Unit of the Analysis, Planning, and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or FAX (703) 604-8932.

Suggestions for Future Audits

To suggest ideas for or to request future audits, contact the Planning and Coordination Branch of the Analysis, Planning, and Technical Support Directorate at (703) 604-8908 (DSN 664-8908) or FAX (703) 604-8932. Ideas and requests can also be mailed to:

OAIG-AUD (ATTN: APTS Audit Suggestions)
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, Virginia 22202-2884

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@DODIG.OSD.MIL; or by writing the Defense Hotline, The Pentagon, Washington, D.C. 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLR	Depot-Level Reparable
DOLARS	Departmental On-line Accounting and Reporting System
GLAC	General Ledger Account Code
JV	Journal Voucher
OMB	Office of Management and Budget

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

January 27, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE DENVER CENTER

SUBJECT: Audit Report on Controls Over Presenting Expense Account Line Items on the FY 1996 Statement of Operations for the Air Force Supply Management Business Area (Report No. 98-056)

We are providing this report for review and comment. Financial statement audits are required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This is the third in a series of reports dealing with Defense Business Operations Fund expense issues.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Director, Defense Finance and Accounting Service Denver Center, did not comment on a draft of this report. Accordingly, we request that the Director, Defense Finance and Accounting Service Denver Center, provide comments on the final report by March 27, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Richard B. Bird, Audit Program Director, at (703) 604-9175 (DSN 664-9175 or e-mail RBird@DODIG.OSD.MIL) or Mr. Carmelo G. Ventimiglia, Audit Project Manager, at (317) 510-3852 (DSN 699-3852 or e-mail CVentimiglia@DODIG.OSD.MIL). See Appendix D for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-056 **January 27, 1998**
(Project No. 5FI-2016.02)

Controls Over Presenting Expense Account Line Items on the FY 1996 Statement of Operations for the Air Force Supply Management Business Area

Executive Summary

Introduction. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires an annual audit of the financial statements of the Defense Business Operations Fund (DBOF). During our audit of the expense accounts, we identified as an audit issue the adequacy of controls over presenting expense account line items on the FY 1996 Statement of Operations for the Air Force Supply Management business area. The FY 1996 DBOF Consolidated Statement of Operations reported $76.4 billion in total expenses; of that amount, $10.6 billion was for the Air Force Supply Management business area.

In December 1996, the Under Secretary of Defense (Comptroller) announced that the DBOF would be eliminated and separate working capital funds would be established. The Air Force Supply Management business became a part of the Air Force Working Capital Fund in FY 1997. This realignment does not affect the matters discussed in this report.

This is the third in a series of reports on issues related to DBOF expenses. The first report dealt with inconsistencies in calculating and presenting expense account line items for the DBOF Supply Management business area on the FY 1995 Statements of Operations. The second report dealt with the recording and reporting of certain FY 1996 expenses of the Defense Commissary Agency. See Appendix B for details of the reports.

Audit Objectives. The overall audit objective was to determine whether the expenses on the FY 1996 DBOF consolidated financial statements were 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. For this part of the audit, we evaluated the procedures followed by the Defense Finance and Accounting Service Denver Center to present expense accounts on the FY 1996 Statement of Operations for the DBOF Air Force Supply Management business area. In addition, we evaluated management controls related to the specific audit objective.

Audit Results. The Defense Finance and Accounting Service Denver Center misrepresented the expenses and the results of operations for the Air Force Supply Management business area in the DBOF Statement of Operations for FY 1996. Because of the lack of supporting documentation for 13 adjustments totaling $60.3 billion and weaknesses in controls over presenting expenses and other financial data, the operating gain of $2.2 billion and the $10.6 billion in expenses

reported in FY 1996 for the Air Force Supply Management business area were subject to a high risk of material misstatement. Unless corrective actions are taken, financial statements for FY 1997 and beyond will continue to be misstated. See Part I for details of the audit results and Appendix A for details on the management control program.

Summary of Recommendations. We recommend that the Director, Defense Finance and Accounting Service Denver Center, verify the accuracy of the crosswalk used to transfer expense account data from the Air Force general ledger accounts to the DoD Standard general ledger accounts in the Air Force Supply Management business area and ensure consistency between data presented in the Accounting Report 1307 and the Statement of Operations. We also recommend that the Director correct the errors identified in this report and restate for comparative purposes the financial data related to the FY 1996 DBOF Air Force Supply Management business area in the FY 1997 Air Force Working Capital Fund financial statements.

Management Comments. The Director, Defense Finance and Accounting Service Denver Center, did not respond to a draft of this report. We request that the Director, Defense Finance and Accounting Service Denver Center, provide comments on the final report by March 27, 1998.

Table of Contents

Executive Summary i

Part I - Audit Results

Audit Background 2
Audit Objectives 3
Controls Over Procedures for Presenting Expense Account Line Items 4

Part II - Additional Information

Appendix A. Audit Process
Scope 16
Methodology 16
Management Control Program 17
Appendix B. Summary of Prior Coverage 18
Appendix C. Adjusting Journal Vouchers Reviewed 20
Appendix D. Report Distribution 22

Part I - Audit Results

Audit Background

The expense accounts audit for the FY 1996 Defense Business Operations Fund (DBOF) financial statements is part of the overall audit of the FY 1996 DBOF consolidated financial statements. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires an annual audit of the DBOF financial statements. The Air Force Supply Management business area of the DBOF includes organizations that provide a wide range of goods and services to Air Force, DoD, and non-DoD customers.

In December 1996, the Under Secretary of Defense (Comptroller) announced that the DBOF would be eliminated and separate working capital funds would be established. The Air Force Supply Management business area will become part of the Air Force Working Capital Fund in FY 1997. This realignment does not affect the matters discussed in this report.

This is the third in a series of reports on issues related to DBOF expenses. The first report dealt with inconsistencies in calculating and presenting expense account line items for the DBOF Supply Management business area on the FY 1995 Statements of Operations. The second report dealt with the recording and reporting of certain FY 1996 expenses of the Defense Commissary Agency. See Appendix B for details of the reports.

DoD Guidance on Financial Reporting. "DoD Guidance on Form and Content of Financial Statements for FY 1996 Financial Activity," October 1996 (DoD Form and Content Guidance), contains guidance for preparing DoD financial statements. DoD 7000.14-R, "Financial Management Regulation," volume 11B, "Reimbursable Operations, Policy and Procedures—Defense Business Operations Fund," December 1994, provides the policies and procedures for reimbursable operations, including guidance on preparing the DBOF Accounting Report 1307, a monthly report on DBOF operations.

The Role of the Defense Finance and Accounting Service Denver Center. The Defense Finance and Accounting Service (DFAS) Denver Center is responsible for preparing the DBOF Accounting Report 1307 and the financial statements for the DBOF Air Force Supply Management business area. The Statement of Operations (and Changes in Net Position), referred to as the Statement of Operations, is the DBOF financial statement that compares revenues and expenses for the reporting period. The difference represents the results of operations. DFAS Denver Center personnel use financial data from field-level organizations to prepare the Accounting Reports 1307 and the financial statements. Financial data in the Air Force Supply Management business area are combined with data from four other Air Force business areas to prepare the Air Force DBOF consolidated financial statements.

Audit Objectives

The overall audit objective was to determine whether the expenses on the FY 1996 DBOF consolidated financial statements were presented fairly in accordance with the other comprehensive basis of accounting described in Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. For this part of the audit, we evaluated the procedures followed by the Defense Finance and Accounting Service Denver Center to present expense accounts on the FY 1996 Statement of Operations for the DBOF Air Force Supply Management business area. In addition, we evaluated management controls related to the specific audit objective. See Appendix A for a discussion of the audit scope, methodology, and management control program. See Appendix B for a summary of prior audit coverage related to the audit objectives.

Controls Over Procedures for Presenting Expense Account Line Items

The DFAS Denver Center misrepresented the expenses and the results of operations for the Air Force Supply Management business area in the FY 1996 DBOF Statement of Operations. This condition occurred because effective procedures were not developed to ensure that adjustments made to the financial data received from field accounting organizations were supported and proper. Further, the DFAS Denver Center personnel did not follow established guidance in presenting the financial data after they made the adjustments. Because of the lack of supporting documentation for 13 adjustments totaling $60.3 billion and weaknesses in controls over presenting expenses and other financial data, the operating gain of $2.2 billion and the $10.6 billion in expenses reported in FY 1996 for the Air Force Supply Management business area were subject to a high risk of material misstatement.

Guidance for Adjusting and Presenting Financial Data

Office of Management and Budget Bulletin No. 94-01. OMB Bulletin No. 94-01 directs each executive agency to prepare financial statements and submit them to the Director of the OMB. The Bulletin prescribes the form of the financial statements and provides instructions on preparing the Statement of Financial Position and the Statement of Operations.

DoD Guidance for Preparing Financial Statements. DoD Form and Content Guidance assigns responsibilities for preparing and submitting the financial statements required by OMB. DoD Components are responsible for the accuracy of the information entered into financial systems or provided to DFAS for reporting in financial statements. The DFAS is responsible for maintaining the integrity of the financial information provided by each reporting entity and for preparing the financial statements. DoD Form and Content Guidance requires organizations to record and report DBOF expenses in accordance with DoD 7000.14-R, volume 11B. The guidance also identifies the DoD general ledger accounts that are to be used to compute each line on the financial statement. DoD 7000.14-R, volume 11B, also requires that the Director, DFAS, establish procedures to ensure that DBOF polices and other regulatory guidance are implemented.

The costs applicable to goods sold to the public and other Federal entities are reported in the Statement of Operations on line 10, Cost of Goods Sold. In the

DBOF Air Force Supply Management business area, line 10 is calculated as follows:

Take: Beginning Inventory—Latest Acquisition Cost

Less: Beginning Allowance for Unrealized Holding Gains and Losses
Plus: Purchases at Cost
Plus: Customer Returns—Credit Given
Plus: Depot-Level Repairable Exchange Credits
Less: Inventory Losses Realized
Less: Ending Inventory—Latest Acquisition Cost
Plus: Ending Allowance for Unrealized Holding Gains and Losses

Equals: Cost of Goods Sold From Inventory

Line 10, Cost of Goods Sold, valued at $10.9 billion, is the major expense account line item on the FY 1996 DBOF Air Force Supply Management financial statements.

After the end of the fiscal year, the DFAS Denver Center prepares an initial version of the financial statements. The initial version is updated based on changes from the customer, further analysis, and audit recommendations. Version 3 of the FY 1996 DBOF Air Force Supply Management financial statements was used to prepare the FY 1996 DBOF consolidated financial statements that the DoD Deputy Chief Financial Officer submitted to the Inspector General, DoD, for audit on March 24, 1997. Version 4 of the financial statements was used to prepare the FY 1996 DBOF consolidated financial statements issued in May 1997. DoD Form and Content Guidance provides guidance on correcting errors in previously issued financial statements, including footnote disclosures.

Use of Data From Air Force Organizations. The systems that account for expenses in the Air Force Supply Management business area use Air Force general ledger accounts to record accounting transactions. Before DFAS Denver Center personnel prepare the Accounting Reports 1307 and the financial statements, the balances in the Air Force general ledger accounts must be crosswalked to the DoD general ledger accounts using the Departmental On-line Accounting and Reporting System (DOLARS). DOLARS is an automated program used by the DFAS Denver Center to receive, process, and report accounting data from field accounting organizations and other sources. DFAS Denver Center personnel sometimes need to adjust field-level financial data. Valid reasons for making adjustments include revaluing the supply management inventory from standard price to latest acquisition cost, classifying revenue and related expenses, and correcting errors. DoD 7000.14-R, "Financial Management Regulation," volume 6, "Reporting Policy and Procedures," February 1996, provides guidance for making adjustments and requires DFAS to support adequately, and justify in writing, any adjustment to the official accounting records. Required documentation includes evidence that supports the need to correct the error and adjust the balances in sufficient detail to provide an audit trail to the source transaction requiring adjustment. Adjustments should be supported by documentation that identifies the general ledger accounts that

need to be adjusted and the amounts of the adjustments. The rationale for the adjustment should be included on the adjusting journal voucher to explain the purpose of the adjustment and why it is being made.

Controls Over Adjustments to Financial Data

The DFAS Denver Center had not developed effective procedures to ensure that adjustments made to field-level financial data were proper and supported. We compared the data in the Accounting Report 1307 for FY 1996 with the data in version 3 of the FY 1996 Statement of Operations for the Air Force Supply Management business area. The Accounting Report 1307 showed that the Air Force Supply Management business area had revenues of $12.8 billion and expenses of $14.8 billion, a net operating loss of $2 billion. While revenues did not change, both the total expenses and the operating loss for FY 1996 on version 3 of the Statement of Operations had increased by $9 billion. Using the DBOF Air Force consolidated trial balance report, we identified the amounts by which DFAS Denver Center personnel adjusted the field-level financial data used to prepare version 3 of the FY 1996 Statement of Operations. DFAS Denver Center personnel made 10 adjustments that affected line 10, Cost of Goods Sold, and line 14, Other Expenses, on version 3 of the FY 1996 Statement of Operations. The 10 adjustments had a combined absolute value of $53.2 billion. Most of the adjustments affected DoD general ledger account code (GLAC) 1529.1A, Realization of Holding Gains and Losses, an inventory allowance account used to compute the Beginning and Ending Allowances for Unrealized Holding Gains and Losses. Appendix C, Table C-1, identifies the 10 adjusting journal vouchers that affected expense account line items on version 3 of the Statement of Operations.

Adjustments Supported by Documentation. Only two of the 10 adjusting journal vouchers, valued at about $9.25 billion, had documentation attached that supported the need for the adjustment. However, the adjustments were not accounted for properly.

o One adjustment (journal voucher [JV] number D96071), valued at $4.7 billion, was initially posted to the correct DoD general ledger accounts. Documentation attached to the original voucher showed that Air Force GLAC 138.02, Inventory—Contractor Repair, was overstated in FY 1995. Changes to the FY 1996 financial statements should have been made because Air Force GLAC 341.15, Prior Year Adjustment—Reparable Support Division FY 1994/1995, and Air Force GLAC 138.02 were not adjusted in the FY 1995 financial statements. DOLARS incorrectly crosswalked Air Force GLAC 341.15 to DoD GLAC 1529.1A, Allowance for Holding Gains and Losses, instead of to DoD GLAC 7400, Prior Year Adjustments. DFAS Denver Center personnel subsequently prepared an adjusting journal voucher that moved $4.7 billion from DoD GLAC 1529.1A to DoD GLAC 7400. The following day, they reversed the entries. Based on our review of version 3 of the FY 1996 Air Force Supply Management financial statements, the $4.7 billion adjustment to correct the overstatement of Air Force GLAC 138.02, Inventory—Contractor Repair, was subsequently crosswalked to

DoD GLAC 7291.3, Other Inventory Losses. That general ledger account is used in computing line 14, Other Expenses. The $4.7 billion adjustment should have been crosswalked to DoD GLAC 7400, Prior Period Adjustments, and not reported as an FY 1996 expense.

o Support for the other adjustment (JV number D96072) identified that an error had been made in the original unit price entered into the Air Force supply system for an inventory item. The unit price was $9.9 million, but was entered as $99.9 million. The Air Force supply system corrected the inventory account in October 1994 and the Defense Accounting Office Hill Air Force Base corrected the accounting records in December 1994. In January 1995, the DFAS Denver Center made an adjusting entry to correct the FY 1994 financial statements. The adjusting entry was reversed in February 1995 and replaced with two adjustments. These entries were not correct because the inventory account was increased when Air Force GLAC 520, Standard Price Adjustment Loss, was crosswalked to the inventory allowance account. To complicate matters further, in January 1996, DOLARS incorrectly crosswalked Air Force GLAC 341.15, Prior Year Adjustment—Reparable Support Division FY 1994/1995, to DoD GLAC 3311.1, Accumulated Operating Results. DFAS Denver Center personnel adjusted the inventory allowance account and DoD GLAC 3311.1. That action did not correct the problem. JV number D96072 moved $4.5 billion from DoD GLAC 1529.1A to DoD GLAC 7400, Prior Period Adjustments. However, DFAS Denver Center personnel reversed the adjustment with JV number D96080. Adjustments to the value of the inventory and the inventory allowance accounts affects the fair presentation of the cost of goods sold and total expenses.

Adjustments Not Supported by Documentation. The adjusting journal vouchers for the remaining eight adjustments, valued at $43.9 billion, were not supported with documentation. Three of the eight adjustments, valued at $34.7 billion, were made to correct crosswalk errors in DOLARS. The first adjustment (JV number D96082), valued at $21.7 billion, was to correct errors that were caused by crosswalking Air Force GLAC 341, Prior Period Adjustments, to DoD GLAC 1529.1A, Realization of Holding Gains and Losses. Air Force GLAC 341 should have been crosswalked to DoD GLAC 7400, Prior Period Adjustments, and included in line 20, Adjustments. DFAS Denver Center personnel made a second adjustment (JV number D96099) for $12.7 billion to correct the first adjustment. A third adjustment (JV number D96100) reduced the dollar value of the second adjustment by $300 million. We requested that DFAS Denver Center personnel provide us with supporting documentation for the three adjustments. DFAS Denver Center personnel stated that they searched but could not find any documentation to support the adjustments. The three unsupported adjustments increased the Ending Allowance for Unrealized Holding Gains and Losses account by $9.27 billion. Increasing the Ending Allowance for Unrealized Holding Gains and Losses account increased the cost of goods sold and total expenses for FY 1996.

DFAS Denver Center personnel made two other adjustments (JV numbers D96079 and D96080), valued at about $9.25 billion, that reversed the two adjusting journal vouchers that were supported by documentation. The two

adjusting journal vouchers did not explain the rationale for the adjustments. The remaining three adjusting journal vouchers (JV numbers D96087, D96089, and D96014), valued at $26.7 million, also were not supported by documentation. Each adjustment should be backed by objective, contemporary, and complete documentation to substantiate that the adjustment was necessary and correct. This documentation could include lists, spreadsheets, and system queries. Unless adjustments are adequately supported and subject to supervisory reviews, considerable risk exists that unnecessary or incorrect adjustments will occur and cause material misstatements to the financial statements.

Summary. The DFAS Denver Center's adjustment process needed improvement. The DFAS Denver Center made adjustments to the financial data provided from field-level organizations that were not adequately documented and controlled. Changes to and reversals of the adjustments further complicated matters and indicated a less than complete understanding of how to account for the adjustments. This report does not contain any recommendations to improve DFAS Denver Center's adjustment process. Inspector General, DoD, Report No. 98-050, "Defense Business Operations Fund Adjustments at the Defense Finance and Accounting Service Denver Center," January 20, 1998, discusses the review of documentation for adjustments to the accounting records at the DFAS Denver Center from which the financial statements were prepared. That report includes the results of this audit in the overall evaluation of the adjustment process at the DFAS Denver Center. Because many of the adjustments made by the DFAS Denver Center attempted to correct crosswalk problems related to expenses, this report includes a recommendation to review and correct problems in crosswalking Air Force general ledger accounts to DoD general ledger accounts. Correcting crosswalk problems will eliminate the need to make some adjustments in the future.

Compliance With Guidance in Presenting Financial Data

After making significant unsupported adjustments to the field-level financial data, DFAS Denver Center did not follow the guidance in OMB Bulletin No. 94-01, DoD Form and Content Guidance, and DoD 7000.14-R, volume 11B, when preparing version 3 of the financial statements. DFAS Denver Center personnel incorrectly calculated line 10, Cost of Goods Sold, because they did not correct the dollar value of the beginning inventory for FY 1996, entered Depot-Level Reparable (DLR) Exchange Credits on two different lines, and included items in Inventory Losses Realized that should have been used to compute other line items in the Statement of Operations and the Statement of Financial Position. Line 10, Cost of Goods Sold, is a major expense account line item on the FY 1996 DBOF Air Force Supply Management financial statements. As a result, the DFAS Denver Center inappropriately reported in version 3 of the financial statements that the Air Force Supply Management business area had an operating loss of $11 billion in FY 1996.

Beginning Inventory. The beginning inventory on the FY 1996 DBOF Air Force Supply Management Financial Statements was incorrect. The inventory account is used in computing the cost of goods sold. DFAS Denver Center personnel did not correct the beginning inventory and make appropriate disclosures in the FY 1996 financial statements in accordance with OMB Bulletin No. 94-01 and DoD Form and Content Guidance. In November 1996, we discussed with DFAS Denver Center personnel the reasons why the Accounting Report 1307 for the first 6 months of FY 1996 showed that the value of the ending inventory increased in the Air Force Supply Management business area by $12 billion while purchases increased by only about $3.4 billion. DFAS Denver Center personnel said the Air Force Logistics Command informed them that they had used the wrong percentages to revalue the excess and condemned inventory for one of the eight Air Force Supply Management business area divisions. Air Force Logistics Command personnel also stated the wrong percentages were used at the end of FY 1995. DFAS Denver Center personnel recalculated the inventory value as of March 31, 1996, but did not adjust the value of the ending inventory for FY 1995, which was also the FY 1996 beginning inventory. Using the percentages, DFAS Denver Center personnel used to recalculate the inventory value of March 31, 1996, we recalculated the beginning inventory for FY 1996. The value of the ending inventory for FY 1995 was understated by about $8 billion. Understating the ending balance of the FY 1995 inventory resulted in an understatement of the net operating results for FY 1995 and a misstatement of the cost of goods sold for FY 1996.

Depot-Level Reparable Exchange Credits. The DFAS Denver Center inappropriately included $3.2 billion of DLR exchange credits twice in calculating cost of goods sold. The DLR exchange credits are customer returns of inventory items in need of repair. Once repaired, the DLR exchange credits are returned to inventory for resale. DFAS Denver Center personnel included $3.2 billion of DLR exchange credits in both DoD GLAC 1529.1E, DLR Exchange Credits, and DoD GLAC 1529.1D, Customer Returns—Credit Given. The two general ledger accounts appear on separate lines in the calculation of cost of goods sold. By including DLR exchange credits on both lines, DFAS Denver Center overstated cost of goods sold and understated the results of operations for FY 1996.

Inventory Losses Realized. The DFAS Denver Center inappropriately included inventory gains, prior period expenses, other assets, and accumulated operating results in calculating Inventory Losses Realized. DoD 7000.14-R, volume 11B, identifies Inventory Losses Realized as inventory losses that are not the result of sales. Because these losses of inventory are not the result of sales, they should not affect the cost of goods sold. However, the inventory losses should be reported as part of either DoD GLAC 7291.1, Excess, Obsolescence, and Spoilage Losses; DoD GLAC 7291.2, Shrinkage and Deterioration Losses; or DoD GLAC 7291.3, Other Inventory Losses. Those three general ledger accounts are used to compute line 14, Other Expenses.

Controls Over Procedures for Presenting Expense Account Line Items

The DoD general ledger accounts in Table 1 were used to calculate Inventory Losses Realized in version 3 of the FY 1996 Statement of Operations.

Table 1. Calculation of Inventory Losses Realized (millions)

GLAC	Account Title	Amount
7291.1	Excess, Obsolescence, and Spoilage Losses	$3,995
7291.2	Shrinkage and Deterioration Losses	(6,810)
7291.3	Other Inventory Losses	4,723
1990.0	Other Assets	9
3311.1	Accumulated Operating Results	(95)
Total		**$1,822**

The amount that should have been reported as Inventory Losses Realized should have included the $4 billion in DoD GLAC 7291.1. The $4 billion represents the amount of DBOF Air Force Supply Management inventory that was sent to the Defense Reutilization and Marketing Service for disposal during FY 1996. Inventory Losses Realized should have also included $4.7 billion of the potential excess and obsolete inventory reported as FY 1996 losses in Air Force GLAC 370.03 Extraordinary Items—Inventory that was crosswalked to DoD GLAC 7291.2.

However, including other information in the calculation of Inventory Losses Realized was inappropriate. Inventory gains, a prior period adjustment, and other items not related to the reduction of the unrealized holding gains and losses accounts that did not result from inventory sales should not have been included in the calculation of Inventory Losses Realized.

Inventory Gains. The $6.8 billion gain shown in DoD GLAC 7291.2, Shrinkage and Deterioration Losses, represented the net total of $11.5 billion in inventory gains from prior years (an adjustment for an overstatement of reported losses in prior years) and the $4.7 billion of potential excess and obsolete inventory reported as FY 1996 losses. By including the inventory gains from prior years in calculating Inventory Losses Realized, DFAS Denver Center personnel understated the cost of goods sold by $11.5 billion. This occurred because DFAS Denver Center personnel did not follow the guidance in DoD 7000.14-R, volume 11B.

Prior Period Adjustment. DFAS Denver Center personnel included a $4.7 billion prior period adjustment in calculating Inventory Losses Realized. The footnote for line J of Part IV—Expenses on the Accounting Report 1307 for FY 1996 identified that a prior period adjustment was made to decrease the value of Air Force GLAC 138.02, Inventory—Contractor Repair, by $4.7 billion. That same data were used to calculate Inventory Losses Realized in the FY 1996 financial statements. Instead of following the DoD Form and Content Guidance and crosswalking the prior period adjustment to line 20, Prior Period Adjustments, on the Statement of Operations, DFAS Denver Center personnel included the prior period adjustment in calculating Inventory Losses Realized. As a result, cost of goods sold was overstated by $4.7 billion.

Other Unrelated Items. DFAS Denver Center personnel included the $9 million reported in DoD GLAC 1990.0, Other Assets, and the negative balance of $95 million reported in DoD GLAC 3311.1, Accumulated Operating Results, in calculating Inventory Losses Realized. The crosswalk in DoD 7000.14-R, volume 11B, does not list those general ledger accounts as part of Inventory Losses Realized because they are not expenses. Including the two general ledger accounts in the calculation of Inventory Losses Realized was not proper and contributed to the understatement of expenses.

Version 4 of the Statement of Operations

Reason for Changes. On April 5, 1997, DFAS Denver Center personnel revised the FY 1996 Statement of Operations for Air Force Supply Management business area and the Air Force DBOF consolidated financial statements. We were told by DFAS Denver Center personnel that they knew that version 3 of the financial statements was incorrect but they were awaiting approval from Headquarters, DFAS, to make the changes. Footnotes on the financial statements included a paragraph identifying a problem in line 14, Other Expenses, on the Statement of Operations that implied that the expenses were misstated because of inventory revaluation adjustments. Further research and analysis by DFAS Denver Center personnel identified numerous problems with the accuracy of the data. Inaccurate crosswalks caused several Air Force general ledger accounts to be used incorrectly in calculating the balances in DoD general ledger accounts.

Scope of Adjustments. DFAS Denver Center used eight adjusting journal vouchers to revise version 3 of the Statement of Operations by a total of $36.2 billion (See Appendix C, Table C-2). However, none of the adjustments were supported with documentation that described the need for the changes and how the amounts were computed. Five of the eight adjusting journal vouchers affected the amounts reported as DBOF expenses by a total of about $16.4 billion. Those adjustments reduced line 15, Total Expenses, by $13.2 billion and increased the net operating results for FY 1996 by the same amount. As a result, version 4 of the Statement of Operations showed an operating gain of $2.2 billion in FY 1996. Table 2 illustrates the effect of the adjustments on the expense account line items and the operating results.

Table 2. Changes in Line Items on the Statement of Operations (millions)

Line Item Title	Version 3	Adjustments	Version 4
Program or Operating Expenses	$ 2,494	0	$ 2,494
Cost of Good Sold	12,632	$ (1,703)	10,929
Depreciation and Amortization	14	0	14
Bad Debts and Write-offs	5	0	5
Other Expenses	8,661	(11,476)	(2,815)
Total Expenses	**$23,806**	**$(13,179)**	**$10,627**
Net Operating Gain (Loss)	$(11,016)	$(13,179)	$2,163

The five adjustments made by the DFAS Denver Center significantly changed the amounts reported on line 10, Cost of Goods Sold, and line 14, Other Expenses. While the value of the expense account line items may be more accurately reflected on version 4 of the Statement of Operations, the reasonableness of the amounts on the Statement of Operations could not be validated because the adjustments were not supported.

Nature of Changes. DFAS Denver Center personnel prepared two adjusting journal vouchers that affected line 10, Cost of Goods Sold. As part of one adjustment (JV number D96118), $7.9 billion in overstatements in the cost of goods sold were corrected. Specifically, the adjustments excluded the $3.2 billion in DLR Exchange Credits from Customer Returns—Credit Given and reduced Inventory Losses Realized by moving $4.7 billion from Inventory Losses Realized to Prior Period Adjustments. The net effect of the adjustment was to decrease cost of goods sold by $1.7 billion. The other adjustment (JV number D96120) attempted to increase the amount of inventory held for sale by increasing an inventory allowance account. The two adjusting journal vouchers also changed the dollar values of the other items that were used to compute cost of goods sold.

The DFAS Denver Center changed line 14, Other Expenses, by processing an adjusting journal voucher (JV number D96119) for $11.5 billion. The adjustment changed the previously reported $8.7 billion balance to an abnormal balance of $2.8 billion. The effect of the change was to inappropriately include FY 1995 expenses as FY 1996 expenses. The adjustment represents the prior period inventory gains and losses in Air Force GLAC 370.03, Extraordinary Items—Inventory. Organizations in the Air Force Supply Management business area recognized that a portion of their ending inventory was excess or obsolete and accounted for that loss in FY 1996. However, DFAS Denver Center personnel used FY 1995 data to adjust the balance on line 14 instead of using the estimated potential loss of $4.7 billion on the ending inventory as of September 30, 1996. The estimated potential loss on the ending inventory for FY 1996 and the residual value of inventory items sent to disposal during the year should have been included in the calculation of line 14. The other two adjustments had a minor effect on line 9, Program or Operating Expenses.

All adjusting journal vouchers must be supported so that the need for changes to field-level financial data can be reviewed and approved. Unnecessary or incorrect adjustments could cause a material misstatement of the financial statements. Without supporting documentation for each of the adjusting journal vouchers, we could not ascertain whether the adjustments were proper and made in the correct amounts.

Continued Need for Emphasis

In Inspector General, DoD, Report No. 97-062, "Consistency in Reporting the Expense Account Line Items of the Defense Business Operations Fund," January 7, 1997, we reported that personnel at the DFAS Centers did not accurately calculate and present expense account line items in the Statements of Operations they prepared for DBOF reporting entities in the Supply Management Business area. We recommended that DFAS review the methodologies used by the DFAS Centers to ensure that they are in compliance with OMB and DoD guidance. Personnel from Headquarters, DFAS, and the Office of the Under Secretary of Defense (Comptroller) have held working sessions with the DFAS Centers and other offices to improve financial reporting. The focus of the working sessions has been to review the methodologies that should be used in reporting allowance accounts and computing cost of goods sold. The DFAS Denver Center has experienced a significant change in the personnel responsible for making adjustments and preparing the DBOF financial statements. Future working sessions should include a detailed review of financial reporting by the DFAS Denver Center. We were told that increased emphasis has been placed by DFAS Denver Center personnel on reviews and approvals during the process of compiling the financial statements. We believe that those actions should improve the process for compiling the DBOF financial statements in the future.

Conclusion

The DFAS Denver Center had not established sufficient controls to ensure that the adjustments made to field-level financial data were properly supported. DFAS Denver Center personnel made numerous adjustments without attaching supporting documentation to the adjusting journal vouchers that provided evidence that the adjustments were needed. Thirteen adjustments, valued at $60.3 billion, affected expense account line items on FY 1996 DBOF Air Force Supply Management financial statements. Without supporting documentation for each of the adjusting journal vouchers, we could not ascertain whether adjustments to accounts that affect the presentation of expense account line items were proper and made in the correct amounts. Many of the adjustments were made to correct problems in crosswalking Air Force general ledger accounts to DoD general ledger accounts. Correcting problems with the crosswalks will eliminate the need for some adjustments. In addition, DFAS Denver Center personnel did not follow the

guidance in OMB Bulletin No. 94-01, DoD Form and Content Guidance, and DoD 7000.14-R, volume 11B, when preparing the FY 1996 DBOF Air Force Supply Management financial statements. While the value of the expense account line items may be more accurately reflected on version 4 of the Statement of Operations, all adjustments must be supported and financial data presented in compliance with OMB and DoD guidance. Unnecessary or incorrect adjustments could cause a material misstatement of the financial statements. The errors that affected the expense account line items should be corrected and the financial data related to the FY 1996 DBOF Air Force Supply Management business area restated for comparative purposes in the FY 1997 Air Force Working Capital Fund financial statements.

Recommendations for Corrective Action

We recommend that the Director, Defense Finance and Accounting Service Denver Center:

1. Verify the accuracy of the crosswalk used to transfer expense account data in the Air Force Supply Management business area from the Air Force general ledger accounts to the DoD general ledger accounts. Review the crosswalks to ensure consistency in the data presented in the Accounting Report 1307 and the Statement of Operations.

2. Correct the errors that affected the expense account line items and restate for comparative purposes the financial data related to the FY 1996 Defense Business Operations Fund Air Force Supply Management business area in the FY 1997 Air Force Working Capital Fund financial statements.

Management Comments Required

The Director, Defense Finance and Accounting Service Denver Center, did not comment on a draft of this report. We request that the Director, Defense Finance and Accounting Denver Center, provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope

As part of our audit of the expense accounts in the FY 1996 DBOF financial statements, we evaluated the procedures followed by the DFAS Denver Center to present expense accounts on the FY 1996 Statement of Operations for the DBOF Air Force Supply Management business area. Total expenses in the Air Force Supply Management business area were $10.6 billion. We reviewed the control procedures for adjusting financial data received from field accounting organizations and other sources. We reviewed a total of 18 adjustments, valued at $89.4 billion, that were dated from November 1996 through April 1997. Fifteen of the 18 adjustments, valued at $69.6 billion, affected expense account line items. We did not verify the accuracy of the field-level financial data that were adjusted.

Methodology

We reviewed the adjustments made by DFAS Denver Center personnel to field-level financial data that affected the expense account lines. We interviewed DFAS Denver Center personnel to determine how they calculated and presented expense account line items. We also reviewed the Air Force Supply Management trial balance and the crosswalks used by the DFAS Denver Center to transfer data from Air Force general ledger accounts to DoD general ledger accounts when preparing the FY 1996 DBOF Statement of Operations for the Air Force Supply Management business area.

Use of Computer-Processed Data. We reviewed the financial data that DFAS Denver Center personnel used to support the adjustments made to the FY 1996 DBOF Air Force Supply Management Statement of Operations. We did not evaluate the general and application controls of DOLARS or the system that summarizes the data reported by systems of the Air Force and DFAS that were adjusted. Although we relied on the data to conduct the audit, we did not test the reliability of the data. Not evaluating the controls and data did not affect the results of the audit.

Audit Type, Dates, and Standards. We performed this financial-related audit from February 1996 through August 1997. Our review was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls as we considered necessary.

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

Management Control Program

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987,* requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of management controls for processing adjustments to field-level financial data and presenting expense account data on the FY 1996 DBOF Statement of Operations for the Air Force Supply Management business area. We also reviewed management's self-evaluation of those management controls.

Adequacy of Management Controls. We identified a material management control weakness as defined by DoD Directive 5010.38 relating to the preparation of adjustments to account balances and the use of financial data to prepare the financial statements. Specifically, DFAS Denver Center personnel made adjustments to account balances without the necessary documentation for supervisory reviews. Consequently, adequate controls had not been established to ensure the accuracy of financial information presented in the financial statements. That weakness was also identified in Inspector General, DoD, Report No. 98-050, "Defense Business Operations Fund Adjustments at the Defense Finance and Accounting Service Denver Center," January 20, 1998. In addition, DFAS Denver Center personnel did not follow OMB and DoD guidance when preparing the financial statements. We identified the same weakness in Inspector General, DoD, Report No. 97-062, "Consistency in Reporting the Expense Account Line Items of the Defense Business Operations Fund," January 7, 1997. The two reports contain recommendations that, if implemented, will provide the needed controls for improving the validity and accuracy of the financial statements. Consequently, this report contains no additional recommendations to correct that material control weakness.

Adequacy of Management's Self-Evaluation. DFAS Denver Center officials did not identify adjustments as an assessable unit and, therefore, did not identify or report the management control weakness identified by the audit.

*DoD Directive 5010.38 had been revised as "Management Control Program," August 26, 1996. The audit was performed under the April 1987 version of the Directive.

at least $16.1 million. The report recommended that the Resource Management Directorate of each region obtain as soon as possible after the end of each month the receiving reports needed to record expenses related to annual agreements and contracts for services. The Defense Commissary Agency concurred with the recommendation and issued a memorandum to the Resource Management Directorate of each region instructing them to promptly obtain the receiving reports needed to record expenses related to annual agreements and contracts for services. The report also recommended that the Director, DFAS Columbus Center, accumulate discounts earned on purchases in GLAC 6500.1G, Cost of Goods Sold—Inventory Gains—Discounts Earned, and include them in calculating the cost of goods sold. The DFAS Deputy Director for Accounting did not agree to reduce the cost of goods sold by the cumulative amount of discounts earned on purchases stating that the accounting for the movement of funds as a result of the discounts earned must be balanced between the Commissary Resale Stock Fund and the Commissary Surcharge Collections Fund. DFAS also stated that a footnote on the Accounting Report 1307 provides full disclosure of the accounting practice used by Defense Commissary Agency in transferring the funds between the two funds. However, we continue to believe that DFAS Columbus Center should accumulate discounts earned on purchases in GLAC 6500.1G, Cost of Goods Sold—Inventory Gains—Discounts Earned, and include them in calculating the cost of goods sold. Continuing to transfer the discounts earned overstates the revenues on the Commissary Surcharge Collections Fund and also overstates the expenses on the Commissary Resale Stock Fund. The Defense Commissary Agency consolidated financial statements did not contain a footnote disclosing the accounting practice. The report is in mediation.

Report No. 97-062, "Consistency in Reporting the Expense Account Line Items of the Defense Business Operations Fund," January 7, 1997. This report states that the DFAS Centers did not consistently calculate and present DBOF expense account line items on the FY 1995 Statement of Operations that they prepared for reporting entities in the Supply Management business area. The lack of uniformity in reporting occurred because of conflicting guidance among OMB Bulletin No. 94-01, DoD Form and Content Guidance, and DoD 7000.14-R, volume 11B, and because personnel at the DFAS Centers not following prescribed procedures. Personnel in the Office of the Under Secretary of Defense (Comptroller) and Headquarters, DFAS, did not effectively monitor the reporting of expenses on the individual Statements of Operations. We recommended that the Under Secretary of Defense (Comptroller) revise DoD guidance to conform with Office of Management and Budget Bulletin No. 94-01. The Under Secretary of Defense (Comptroller) concurred with the recommendation and revised DoD Form and Content Guidance and is revising DoD 7000.14-R, volume 11B, to enable the DFAS Centers to more accurately calculate and present expense account line items on the Statement of Operations.

Appendix C. Adjusting Journal Vouchers Reviewed

Tables C-1 and C-2 identify the 18 adjusting journal vouchers we reviewed. Table C-1 identifies the 10 adjusting journal vouchers that affected expense account line items in version 3 of the Statement of Operations. Table C-2 identifies the eight adjusting journal vouchers that affected the account balances reported in version 4 of the Statement of Operations. Five of the eight vouchers effected expense account line items.

Table C-1. Adjusting Journal Vouchers Included in Version 3 of the Statement of Operations

Journal Voucher Number	Dollar Amount (thousands)	Nature of Adjustment
Unsupported (Undocumented)		
D96082	$21,663,692	Corrects crosswalk errors
D96099	12,694,681	Adjusts JV D96082
D96100	300,000	Adjusts JV D96082
D96079	4,723,236	Reverses JV D96071
D96080	4,530,427	Reverses JV D96072
D96087	30	Corrects errors identified through reconciliations
D96089	21,007	Corrects JV D96087
D96014	5,639	Corrects errors identified by others
Subtotal	**$43,938,712**	
Supported		
D96071	4,723,236	Corrects crosswalk error
D96072	4,530,427	Corrects Hill Air Force Base correction
Subtotal	**$9,253,663**	
Total	**$53,192,375**	

Table C-2. Adjusting Journal Vouchers Included in Version 4 of the Statement of Operations

Journal Voucher Number	Dollar Amount (thousands)	Nature of Adjustment
D96117	$ 2,387	Reduces operating expenses and recategorizes some expenses
D96118	1,702,929	Corrects calculation error on line 10, Cost of Goods Sold
D96119	11,475,615	Corrects line 14 overstatement of inventory losses
D96120	3,175,493	Adjusts inventory allowance account
D96121	4,642,828	Corrects crosswalk error
D96122	152	Corrects JV D96117
D96123	9,285,656	Corrects JV D96121
D96124	5,948,366	Recategorizes adjustments made to Accumulated Operating Results
Total	**$ 36,233,426**	

Appendix D. Report Distribution

Office of the Secretary of Defense

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

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

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

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
  Director, Defense Finance and Accounting Service Denver Center
Director, Defense Logistics Agency
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

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

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology, 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

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, produced this report.

F. Jay Lane
Richard B. Bird
Carmelo G. Ventimiglia
Gary S. Woodrum
Deborah Curry

Appendix B. Summary of Prior Coverage

The Inspector General, DoD, has published two audit reports discussing expense issues related to Defense Business Operations Fund. In addition, the Inspector General, DoD, has published an audit report related to the adjustment process at the DFAS Denver Center. The three reports are summarized below.

Report No. 98-050, "Defense Business Operations Fund Adjustments at the Defense Finance and Accounting Service Denver Center," January 20, 1998. This report states that the DFAS Denver Center did not have adequate supporting documentation that conformed to DoD 7000.14-R for 111 adjustments totaling $217.5 billion made to the Air Force, U.S. Transportation Command, and Joint Logistics Service Center FY 1996 DBOF account balances. In many instances, adjustments were made to the same accounts because the adjustments were recorded incorrectly, reversed, reestablished, decreased, or increased. However, we could not determine the validity of the adjustments because of the lack of supporting documentation. These conditions existed because the DFAS Denver Center did not have adequate management controls over the processing of adjusting journal vouchers. In addition, DFAS had not provided adequate written guidance for preparing adjusting journal entries. As a result, the FY 1996 DBOF financial statements for the Air Force, U.S. Transportation Command, and Joint Logistics Service Center were subject to higher risk for material misstatement. Officials at the DFAS Denver Center informed us that they have initiated corrective actions to require more definitive documentation and explanation for adjustments to be made in the future. Recommendation were made to the Director, DFAS, to issue written guidance for making adjustments, and to establish procedures to ensure that adequate explanation and supporting documentation are provided for adjustments. The DFAS Deputy Director for Accounting nonconcurred with the recommendation to issue written guidance for making adjustments, and partially concurred with the recommendation to establish procedures at the DFAS Denver Center for making adjustments. The final report requested that the Director, DFAS, reconsider and provide additional comments.

Report No. 97-223, "Recording and Reporting Expenses of the Defense Commissary Agency," September 30, 1997. This report states that internal controls over the recording and reporting of certain expenses were generally adequate. However, Defense Commissary Agency personnel in four of the six regions located in the continental United States did not properly record and report expenses on annual agreements and contracts for services. In addition, DFAS Columbus Center personnel did not follow DoD guidance in accounting for