Audit Report

DEFENSE FINANCE AND ACCOUNTING SERVICE WORK ON THE NAVY GENERAL FUND 1996 FINANCIAL STATEMENTS

Report Number 98-073 February 12, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CFO	Chief Financial Officer
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
FASAB	Federal Accounting Standards Advisory Board
GAO	General Accounting Office
IG	Inspector General
NAS	Naval Audit Service
NHFS	Navy Headquarters Financial System
OM&S	Operating Materials and Supplies
OMB	Office of Management and Budget
SFFAS	Statement of Federal Financial Accounting Standards
STARS	Standard Accounting and Reporting System

February 12, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
AUDITOR GENERAL, DEPARTMENT OF THE NAVY

SUBJECT: Audit Report on Defense Finance and Accounting Service Work on the Navy General Fund FY 1996 Financial Statements (Report No. 98-073)

We are providing this report for review and comment. The audit was performed in response to the Chief Financial Officers Act of 1990 requirement for financial statement audits. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Comments from the Assistant Secretary of the Navy (Financial Management and Comptroller) and the Defense Finance and Accounting Service conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required from those parties. The Under Secretary of Defense (Comptroller) did not respond to the draft report. We request that the Under Secretary of Defense (Comptroller) provide comments on Recommendations 4. a. and 4. b. by April 13, 1998.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Richard B. Bird, Audit Program Director, at (703) 604-9145 (DSN 664-9145) (rbird@DODIG.OSD.MIL) or Mr. Joel K. Chaney, Audit Project Manager, at (216) 522-6091, extension 235 (DSN 580-6091) (jchaney@DODIG.OSD.MIL). See Appendix E for the report distribution. The audit team members are listed inside the back cover.

David Steensma

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Office of the Inspector General, DoD

Report No. 98-073 **February 12, 1998**
(Project No. 6FI-2024)

Defense Finance and Accounting Service Work on the Navy General Fund FY 1996 Financial Statements

Executive Summary

Introduction. We are providing this report for your review and comment. We performed this financial statement audit in response to the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. Our audit focused on the Defense Finance and Accounting Service Kansas City Center, which compiled financial information and prepared both budgetary reports and internal financial statements for the Marine Corps, and on the Defense Finance and Accounting Service Cleveland Center, which consolidated the financial information for Navy and Marine Corps and compiled the financial statements for the Department of the Navy. The Navy financial statements reported assets of $453.4 billion, liabilities of $13.3 billion, total revenues of $63.2 billion, and expenses of $63.3 billion for the fiscal year ended September 30, 1996. The Naval Audit Service was unable to render an opinion on the Statement of Financial Position because of inadequate financial systems and incomplete and unauditable supporting records. We concurred with the Naval Audit Service. (For details, see "Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Auditor's Opinion," March 1, 1997.)

Audit Objectives. The overall audit objective was to determine whether the Defense Finance and Accounting Service (DFAS) Cleveland and Kansas City Centers consistently and accurately compiled financial data from field activities and other sources for the FY 1996 Navy General Fund and Navy Defense Business Operations Fund financial statements. We did not review the compilation of the Navy Defense Business Operations Fund financial statements because the final version of the statements was not issued by the Department of the Navy and DFAS Cleveland Center in time to perform the audit field work. In addition, we planned to determine whether FY 1996 ending balances were supportable for use as beginning balances for FY 1997 . However, we could not because data were inadequate (see Appendix C). We reviewed the adequacy of the management control program as applicable to the overall audit objective.

Audit Results. FY 1996 was the first year that financial statements were prepared for the Navy General Fund. Preparation of these financial statements represented a major step toward improving financial management by the Navy and DFAS. However, improvements are still needed to increase their reliability and to ensure compliance with Office of Management and Budget requirements and Federal Accounting Standards. Data for the FY 1996 Navy General Fund financial statements were not generated by an integrated, transaction driven, standard general ledger accounting system, and adequate audit trails were not established to crosswalk data from claimant-level to departmental accounting systems. Accounts Receivable, Net (Governmental) was misstated because DFAS did not establish an effective method for estimating an allowance for uncollectible receivables. In addition, supplemental information in the Notes to the Statement of Financial Position did not provide accurate disclosure of Inventory, Operating Materials and Supplies, and Fund Balance with Treasury. As a result, management cannot fully rely on financial data used to prepare the financial

statements. The inadequate and incomplete disclosure of financial data in these statements could lead to their misinterpretation. See Part I for a discussion 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, require the DFAS Cleveland and Kansas City Centers to establish audit trails between financial accounting systems used to compile data for the Navy financial statements. We also recommend that the Director, Defense Finance and Accounting Service, require the DFAS Cleveland Center to establish a systemic methodology to determine the allowance for uncollectible Accounts Receivable, to establish procedures for supervisory review and approval of amounts reported in the Notes to the financial statements, and to reclassify and separately disclose In-Transit Problem Disbursements in Note 31 of the FY 1997 financial statements. We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) provide the DFAS Cleveland Center with guidance for the reporting and disclosure of Inventory, Net. We also recommend that the Under Secretary of Defense (Comptroller) provide the DFAS with specific guidance for the accounting and reporting of Operating Materials and Supplies that implements the intent of the Federal Accounting Standards Board and covers the disclosure of amounts included in Fund Balance with Treasury related to Closed Appropriations.

Management Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) and the Defense Finance and Accounting Service concurred with the audit recommendations and identified corrective actions to be implemented. The Under Secretary of Defense (Comptroller) did not provide comment to the draft of this report. We request the Under Secretary of Defense (Comptroller) to provide comments to the final report by April 13, 1998. See Part I for a complete discussion of the management comments and Part III for the complete text of management comments.

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Part I - Audit Results

Audit Background

Chief Financial Officers Act of 1990. Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990, requires the annual preparation and audit of financial statements for Government agencies and for trust funds, revolving funds, and substantial commercial activities of Executive departments and agencies. The Chief Financial Officers (CFO) Act also requires the Inspectors General (IGs) to audit the financial statements in accordance with Generally Accepted Government Auditing Standards. Public Law 103-356, "Federal Financial Management Act of 1994," October 13, 1994, amends the CFO Act of 1990, requiring each Executive agency to issue agency-wide, audited financial statements beginning in FY 1996 and annually thereafter.

Defense Finance and Accounting Service. The Defense Finance and Accounting Service (DFAS) was established as the result of DoD Directive 5 118.5, "Defense Finance and Accounting Service, " November 26, 1990. DFAS is chartered to standardize and consolidate DoD accounting and finance operations formerly carried out by the various DoD organizations and Military Departments. DFAS Headquarters is in Arlington, Virginia, and the DFAS centers are in Cleveland, Ohio; Columbus, Ohio; Denver, Colorado; Indianapolis, Indiana; and Kansas City, Missouri. DFAS also has many smaller operating locations.

The DFAS Cleveland and Kansas City Centers. The DFAS Cleveland and Kansas City Centers prepared the Navy financial statements using both consolidated and unconsolidated financial data from field-level organizations. The DFAS Cleveland and Kansas City Centers agreed that the financial statement data produced by the DFAS Kansas City Center would be used in preparing the Navy's CFO financial statements for FY 1996. The compilation process was complicated by the fact that the data submitted to the DFAS Cleveland and Kansas City Centers were not generated by an integrated, transaction driven, standard general ledger system. As a result, the DFAS Cleveland Center used a complex process to compile the Navy statements from financial information provided by accounting subsystems; over 80 percent of all assets reported were provided by data calls. In addition, the DFAS Cleveland and Kansas City Centers manually prepared the statements using information from several different accounting systems.

At both Centers, personnel prepared budget execution reports using data from field-level accounting systems for review and certification by Navy and Marine Corps organizations. The compilation process began with the transfer of budget execution reports and supporting accounting data to Departmental Accounting. Departmental Accounting personnel consolidated the accounting data at the

appropriation level and recorded adjusting and closing entries. The adjusting entries included adjustments to:

o correct accounting data so that it agreed with the certified budget status reports;

o record in-transit and unmatched transactions to Accounts Payable and Accounts Receivable; and

o record financial information that was available at the appropriation level but not at the claimant level.

After the consolidation and adjustment of the accounting data, Departmental Accounting personnel prepared the DD Form 1176 "Report on Budget Execution," from the consolidated data in the Navy Headquarters Financial System (NHFS). This report was prepared off-line for the reopened Closed Appropriations using manual spreadsheets because accounting records for the appropriations were no longer maintained in the accounting systems. The CFO Project Office at the DFAS Kansas City Center prepared internal financial statements based on the Report on Budget Execution and provided both the Report on Budget Execution and the financial statements to the DFAS Cleveland Center.

The CFO Reporting Branch at the DFAS Cleveland Center crosswalked trial balance data from the NHFS and other financial data accumulated at the appropriation level to financial statement line items. This created appropriation-level financial statements that were then combined into the Consolidated Navy General Fund financial statements. The CFO Reporting Branch also recorded adjustments at the consolidated financial statement line item level such as the adjustments to record Inventory ($41.4 billion); Property, Plant, and Equipment ($340.9 billion); Accrued Liabilities ($3.0 billion); and allowances such as uncollectible Accounts Receivable ($78.6 million). For the reopened Closed Appropriations, the CFO Reporting Branch crosswalked the Report on Budget Execution into the financial statements as general ledger account values were not available for these appropriations. The CFO Reporting Branch prepared the financial statements for the Department of the Navy to include supporting footnotes.

FY 1996 Navy General Fund Financial Statements. The IG, DoD, delegated the audit of the FY 1996 Navy General Fund financial statements to the Naval Audit Service (NAS). The IG, DoD, assisted the NAS by performing the required audit work at DFAS Cleveland Center, including examining processes used to prepare the Navy financial statements.

The Statement of Financial Position reported assets of $453.4 billion and liabilities of $13.3 billion as of September 30, 1996. The Statement of

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o correct accounting data so that it agreed with the certified budget status reports;

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The Statement of Financial Position reported assets of $453.4 billion and liabilities of $13.3 billion as of September 30, 1996. The Statement of

Operations and Changes in Net Position reported total revenues of $63.2 billion and expenses of $63.3 billion for the fiscal year ended September 30, 1996. The Navy General Fund consists of money appropriated by Congress for operating Navy and DoD organizations. Navy entity General Funds that must be reported on the CFO financial statements are listed in Appendix D.

Audit Objectives

The overall audit objective was to determine whether the DFAS Cleveland and Kansas City Centers consistently and accurately compiled financial data from field activities and other sources for the FY 1996 Navy General Fund and the Navy Defense Business Operations Fund (DBOF) financial statements. We did not review the compilation of the Navy DBOF financial statements because the final version was not issued by the Department of the Navy and DFAS Cleveland Center in time to perform the audit field work. In addition, we had planned to determine whether FY 1996 ending balances reported by the DFAS Cleveland Center are usable as beginning balances for the FY 1997 financial statements. However, we could not because data were inadequate. (See Appendix C.) We reviewed the adequacy of the management control program as it related to the overall audit objective. Appendix A discusses the audit scope and methodology and the management control program. Appendix B summarizes prior coverage related to the audit objectives.

Compilation of the Navy General Fund Financial Statements

FY 1996 was the first year that financial statements were prepared for the Navy General Fund. Preparation of these financial statements represented a major step toward improving financial management by the Navy and DFAS. However, improvements are still needed to increase their reliability and to ensure compliance with Office of Management and Budget (OMB) requirements and Federal Accounting Standards. Data for the FY 1996 Navy General Fund financial statements were not generated by an integrated, transaction driven, standard general ledger accounting system, and adequate audit trails were not established to crosswalk data from claimant-level to departmental accounting systems. Accounts Receivable, Net (Governmental) was misstated because DFAS did not have an effective method for estimating an allowance for uncollectible receivables. In addition, supplemental information in the Notes to the Statement of Financial Position did not accurately disclose Inventory, Operating Materials and Supplies, and Fund Balance with Treasury. The problems with financial data reliability and lack of controls over the compilation of data occurred because:

o Accounting systems were inadequate and did not comply with financial reporting requirements;

o Guidance for reporting Inventory ($41.4 billion) and Operating Materials and Supplies ($27,000) was insufficient and unclear; and

o Guidance and procedures for disclosing footnote information were inadequate.

As a result, management cannot fully rely on the financial data used to prepare financial statements. The inadequate and incomplete disclosure of financial data in these statements could lead to their misinterpretation.

Requirements and Standards for Financial Reporting

Public Law 104-208, “Federal Financial Management Improvement Act of 1996,” states, “Each agency shall implement and maintain financial systems tha comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level.” Office of Management and Budget (OMB) Circular No. A- 127 (Revised), “Financial Management

Systems," July 23, 1993, prescribes policies and standards for Executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems. DoD 7000.14-R, "DoD Financial Management Regulation, " volume 1, "General Financial Management Information, Systems, and Requirements, " March 16, 1993, establishes 13 Key Accounting Requirements with which an accounting system must reasonably comply.

The Federal Accounting Standards Advisory Board (FASAB) was established by the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General to consider and recommend accounting principles for the Federal Government. The FASAB communicates its recommendations by publishing recommended accounting standards after consideration from Government organizations and the public. When the FASAB decides to adopt the recommendations, the standard is published by OMB and General Accounting Office (GAO) and then becomes effective. Two Statements of Federal Financial Accounting Concepts and seven Statements of Federal Financial Accounting Standards (SFFASs) have been published. Federal agencies will follow the SSFAS for reporting under the Federal Financial Management Act of 1994.

Accounting Systems

Deficiencies existing in the accounting systems used by the DFAS Cleveland Center to produce the FY 1996 General Fund financial statements limited the reliability and accuracy of financial statement data. Data used in the FY 1996 Navy General Fund financial statements that were compiled by the DFAS Cleveland and Kansas City Centers were not generated by an integrated, transaction driven, standard general ledger accounting system. Although the DFAS Centers were aware of the deficiencies in the accounting systems and continue with efforts to improve their adequacy, the Centers had not implemented sufficient procedures and controls to ensure the integrity and accuracy of the accounting data used to compile the Navy General Fund financial statements. The DFAS Cleveland and Kansas City Centers had not established adequate audit trails (that is, crosswalks between claimant-level and departmental accounting systems). In addition, the DFAS Cleveland Center had not established an adequate methodology for the aging of delinquent receivables, which is necessary for estimating the allowance for uncollectible receivables. Until reporting requirements and accounting standards are met, the Department of the Navy will continue to receive disclaimers of opinion on its General Fund financial statements.

Compliance With Financial Reporting Regulations. The DFAS Cleveland Center must ensure that the systems used to compile field-level accounting data (Standard Accounting and Reporting System [STARS] Claimant Accounting Module, STARS Headquarters Claimant Module, and the Responsible Office Automated Resource System) comply with the 13 Key Accounting Requirements contained in DoD 7000.14-R, volume 1. The DFAS Cleveland Center reported in the 1996 Annual Statement of Assurance that its accounting systems were not in compliance with those requirements and that an Interim Migratory Accounting System strategy was being implemented to transition the DFAS Cleveland Center to compliant systems. DoD 7000.14-R, Key Accounting Requirement Number 1, "General Ledger Control and Financial Reporting," states that the accounting system must have general ledger control and maintain an appropriate account structure approved by DoD. The requirement addresses the mandatory fiduciary general ledger and reporting requirements at the departmental, claimant, and field levels.

The accounting systems used to compile the Navy General Fund financial statements did not use the DoD Standard General Ledger format. For example, the claimant-level accounting systems (STARS-Claimant Accounting Module, STARS-Headquarters Claimant Module, and the Responsible Office Automated Resource System) used the Uniform General Ledger chart of accounts format. These accounting systems produced year-end closing statement reports at the claimant level. The closing statement reports were then sent to the major claimants for verification and certification. After certification, the data was transferred to the Navy Headquarters Financial System (NHFS), the departmental accounting system used to produce the financial statements. During the transfer, accounting data recorded in the Uniform General Ledger Chart of Accounts format were converted to the Navy Uniform Chart of Accounts format used by the NHFS. Conversions and crosswalks between the field-level accounting systems and the NHFS increased the probability of errors in the financial statements.

Audit Trails. The DFAS Cleveland and Kansas City Centers accounting systems did not contain audit trails that would support the transfer of financial data from claimant-level to departmental accounting systems. DoD 7000.14-R Key Accounting Requirement Number 8, "Audit Trails," requires that systems allow for the tracing of transactions to individual source records. Such audit trails ensure that transactions are properly accumulated and correctly classified, coded, and recorded into all affected accounts. Audit trails should allow a transaction to be traced from initiation through processing to final reports. A key test of the adequacy of an audit trail is whether tracing the transaction either forward from the source or backward from the result permits verification of the amount recorded or reported.

The DFAS Cleveland Center performed limited testing of the automated process to transfer financial data between claimant-level and departmental accounting

systems. The DFAS Cleveland Center established crosswalks for FY 1995 general ledger data transferred between the STARS-Claimant Accounting Module and NHFS for several financial statement line items. These crosswalks verified that the transferred data were accurately recorded in the proper general ledger accounts for the financial statement line items that were tested. Similar crosswalks were not established for the STARS-Headquarters Claimant Module and Responsible Office Automated Resource System. The lack of an established crosswalk limits the ability to trace financial data between systems or from the financial statements to its source.

The DFAS Cleveland Center was aware of these deficiencies and had implemented an Interim Migratory Accounting System strategy to transition to a integrated, transaction-driven, standard general ledger system but was unable to adequately establish and document the necessary crosswalks in the interim. Also, the limited crosswalk testing was neither documented nor available for our review. The testing performed was insufficient to allow for reliance on the data transferred from claimant-level systems to the NHFS.

Similarly, the DFAS Kansas City Center did not have a documented audit trail from the Headquarters Accounting System backwards to the Standard Accounting Budgeting and Reporting System, the field-level accounting system. Departmental accountants queried the Headquarters Accounting System to establish amounts reported in the Report on Budget Execution. For example, the DFAS Kansas City Center reported Reimbursements and Other Income totaling $361.6 million in the Report on Budget Execution for the Operation and Maintenance, Marine Corps, appropriation. The Headquarters Accounting System did not provide an audit trail to the supporting transactions for the $361.6 million. The departmental accountants could provide the transactions from the Standard Accounting Budgeting and Reporting System supporting $265.1 million of that amount. However, they could not provide the information supporting the remaining $96.5 million. The lack of an established crosswalk limits the ability to trace financial data to their source. The DFAS Kansas City Center was aware of this deficiency and planned to address the establishment of audit trails in their Interim Migratory Accounting System program. Currently, the Headquarters Accounting System was scheduled for replacement by the Standard Accounting Budgeting and Reporting System by October 1997.

Allowance for Uncollectible Receivables. The Navy General Fund financial statements reported Accounts Receivable, Net (Governmental), totaling $1.9 billion. The Accounts Receivable balance was reduced by $78.6 million to record an allowance for uncollectible receivables. However, the method used by the DFAS Cleveland Center for estimating the allowance for uncollectible receivables was neither systematic nor comprehensive. As a result, Accounts Receivable, Net was misstated. The accounting systems used to capture and

report Department of the Navy financial data were not able to perform the formal aging of delinquent receivables necessary to establish an accurate estimate of allowances for uncollectible accounts.

SFFAS Number 1, "Accounting for Selected Assets and Liabilities, " March 30, 1993, states, "losses due to uncollectible amounts should be measured through a systematic methodology. The systematic methodology should be based on analysis of both individual accounts and a group of accounts as a whole. " Additionally, agencies should disclose the major categories of receivables by amount and type, the methodology used to estimate the allowance for uncollectible amounts, and the total allowance.

DoD 7000.14-R, volume 4, "Accounting Policy and Procedures, " January 11, 1995, requires DoD Components to establish allowances for uncollectible accounts. In addition, the agencies are required to age delinquent receivable accounts reflecting amounts owed to the Government. DoD Components operating under this regulation must ensure that their accounting systems provide for formal aging of delinquent receivables and the establishment of allowances for uncollectible accounts.

The DFAS Cleveland Center attempted to establish the allowance for uncollectible receivables by using data on four appropriations for which historical data existed in the Report on Receivables Due from the Public. The percentages used to estimate the allowance for uncollectible receivables for these four appropriations were correctly determined on an individual basis by dividing the bad debt expense for each appropriation by that appropriation's respective Accounts Receivable. For the four appropriations, bad debt expense ($23,322,345) represented 12.8 percent of the Non-Federal (Governmental) Accounts Receivable ($182,632,169). This percentage was used to estimate the allowance for uncollectible receivables for the four appropriations.

The method that DFAS Cleveland used to estimate the allowance for uncollectible receivables for the remaining appropriations did not comply with the intent of SFFAS Number 1 or DoD 7000.14-R. The DFAS Cleveland Center divided the amount written off for the four appropriations ($23,322,345) by the total Non-Federal (Governmental) Accounts Receivable, for all appropriations from the Report on Receivables ($927,28 1,555). The resulting percentage, 2.5 percent, was applied to each of the remaining appropriations with the exception of the National Defense Sealift Fund, appropriation 4557, which had an entity receivable of $2.1 billion erroneously recorded. The establishment of procedures to age receivables for each appropriation is necessary to accurately estimate the allowance for uncollectible receivables.

The DFAS Cleveland Center is making progress in establishing a more accurate allowance for uncollectible receivables. The Center issued a memorandum, November 26, 1996, requiring the DFAS Cleveland Center operating locations

to locally develop allowances for uncollectible accounts in accordance with DoD 7000.14-R, volume 1 1B, "Reimbursable Operations, Policy and Procedures--Defense Business Operations Fund, " December 1994.

Reporting Guidance

Reporting guidance provided to the DFAS Cleveland and Kansas City Centers was not consistent with SFFAS. Specifically, the guidance for reporting Inventory and Operating Materials and Supplies (OM&S) was inadequate and resulted in inconsistent and incomplete disclosure of financial information in the Notes to the Financial Statements.

Inventory, Net. The Navy General Fund financial statements reported Inventory, Net, totaling $41.4 billion In its report, "Department of the Navy Fiscal Year 1996 Annual Financial Report: Ammunition and Ashore Inventory (97-0048)," the NAS reports that the Department of the Navy used an inappropriate and inaccurate source--the Supply System Inventory Report--for reporting the value of ammunition on the financial statements. As a result, the ammunition value contained material omissions of $20.5 billion and improper inclusions of $11.6 billion. In addition, ashore inventory assets valued at $3.4 billion were not included in the Inventory, Net, balance. Besides the misstatement of the value of Inventory, Net, the Navy statements did not provide adequate disclosure of Inventory, Net (Note 8).

Note **8** to the FY 1996 Navy General Fund financial statements does not categorize inventory in accordance with the Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 29, 1993. The form and content guidance specifies the information to be disclosed as a footnote to the Statement of Financial Position. The guidance for Inventory, Net (Note 8), specifies disclosure of:

- general composition of inventory;
- basis for determining inventory values; and
- balances for the following categories of inventory:
  - inventory held for current sale,
  - inventory held in reserve for future sale,
  - excess, obsolete, and unserviceable inventory, and
  - inventory held for repair.

On December 20, 1996, the Deputy, Chief Financial Officer, DoD, issued additional guidance directing that War Reserve Materiel be identified and disclosed as a separate inventory category. A prior IG, DoD, audit report, (Report No. 97-100, "Asset Presentation on Military Department General Fund Financial Statements," February 25, 1997) recommended that the Under Secretary of Defense (Comptroller) revise guidance to include war reserves as a separate line item on the Statement of Financial Position, removing it from inventory. DoD nonconcurred with this recommendation, and the issue is currently in mediation. This section addresses the Navy's disclosure under the December 20, 1996, guidance that was available to the DFAS Cleveland Center at the time of financial statement preparation.

The inadequate disclosure occurred because the Assistant Secretary of the Navy (Financial Management and Comptroller) did not provide sufficient guidance to the DFAS Cleveland Center. The Assistant Secretary of the Navy (Financial Management and Comptroller) directed the DFAS Cleveland Center to use the inventory values reported in the Supply System Inventory Report in reporting Inventory, Net, in the FY 1996 Navy General Fund financial statements. However, the Assistant Secretary of the Navy (Financial Management and Comptroller) did not provide guidance for extracting the data from the Supply System Inventory Report.

The Supply System Inventory Report provides information to categorize the inventory that would materially change the footnote disclosure. First, the inventory held in support of the Approved Acquisition Objective excluding War Reserve Materiel should be classified as inventory held for sale. Second, materiel held in support of economic and contingency retention stock should be classified as inventory held for future sale. Finally, the inventory held as potential reutilization and disposal stock should be classified as Excess, Obsolete, and Unserviceable inventory. Table 1 compares the amounts reported in footnotes to the Navy financial statements with the disclosure that we believe was required by form and content guidance in OMB Bulletin No. 94-l.

Table 1. Footnote Differences

Inventory Account	Navy Statements [thousands)	Form and Content Guidance [thousands)
Held for Current Sale	$ 44	$ 6,982,490
Held for Future Sale	41,413,657	297,905
War Reserve Materiel	27,418	34,148,851
Excess, Obsolete, & Unserviceable	0	11,873
Total	**$41,441,119**	**$41,441,119**

Operating Materials and Supplies. The Navy General Fund financial statements reported Operating Materials and Supplies, Net, totaling $27,000. The NAS reported that except for the amount applicable to the trust fund, the Navy expensed or misclassified these assets. (See "Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Auditor's Opinion (022-97)," March 1, 1997.) The NAS estimated that $7.8 billion of OM&S aboard ships and with the Marine Corps was not reported on the financial statements. Our review of the compilation of the financial statements, in support of the NAS disclaimer of opinion, indicated that the Navy did not report OM&S held by the Marine Corps totaling $96 million on the Statement of Financial Position and did not include that amount in program and operating expenses of the period. This occurred because guidance from the Assistant Secretary of the Navy (Financial Management and Comptroller) was inconsistent with the requirements of SFFAS Number 3, "Accounting for Inventory and Related Property," October 27, 1993.

SFFAS Number 3 defines OM&S as consisting of tangible personal property to be consumed in normal operations. OM&S differs from inventory in that inventory is tangible personal property that is being held or produced for sale or is to be consumed in the production of goods for sale or in the provision of services for a fee. According to the SFFAS Number 3, the primary method for recognizing OM&S is the consumption method. Under the consumption method, OM&S are recognized and reported as assets when they are purchased and expensed when issued to an end user in the course of normal operations. SFFAS Number 3 defines an end user as any component of a reporting entity that obtains goods for direct use in its normal operations. However, an entity that maintains or stocks OM&S for future issuance shall not be considered an end user.

The Under Secretary of Defense (Comptroller) has not issued guidance on reporting OM&S. On July 19, 1996, the Assistant Secretary of the Navy (Financial Management and Comptroller) issued a memorandum providing guidance for compiling data reported in the FY 1996 financial statements. The memorandum directed that no value would be reported for operating supplies because this type of item should be expensed and not reported as an asset. The Assistant Secretary of the Navy (Financial Management and Comptroller) based this guidance on discussions with the Under Secretary of Defense (Comptroller) and on a March 7, 1996, memorandum from the Under Secretary of Defense (Comptroller) to the DFAS. This memorandum directed that DFAS should follow the existing policy that ammunition held by Marine Corps activities for later distribution to end users not be reported as an asset unless that ammunition is reported in the Supply System Inventory Report.

The guidance issued by the Assistant Secretary of the Navy (Financial Management and Comptroller) was inconsistent with the requirements of

SFFAS Number 3 and resulted in the understatement of Operating Materials and Supplies in the financial statements. That guidance did not allow the Marine Corps to report $96 million of OM&S in the financial statements. The OM&S was consumable material that Marine Corps activities held for distribution to the end user. The OM&S was procured and managed by a general fund activity, not by the DoD supply system. We believe this material is the type of asset that SFFAS Number 3 requires to be reported as OM&S.

Footnote Disclosures

Footnote disclosures to the Navy FY 1996 General Fund financial statements for Fund Balance with Treasury, reopened Closed Appropriations, and Problem Disbursements were inadequate and inaccurate. As a result, financial data could be misinterpreted or misconstrued. In addition, procedures were not in place to ensure footnote disclosures complied with OMB Bulletin 94-01, DoD 7000.14-R, and the SFFAS. OMB Bulletin 94-01 states, "the notes to principal statements, which are an integral part of the principal statements, shall provide additional disclosures necessary to make the principal statements fully informative and not misleading. " In addition, DoD 7000.14-R, volume 6, "Reporting Policy and Procedures, " February 1993, states:

> The notes to the principal statements should contain all disclosures necessary to make the financial statement fully informative and to avoid misinterpretations. The notes should be an integral part of the principal statements. The notes should contain a discussion of all accounting policies, and any deviations from the standards contained in the policies and procedures published in this Regulation.

Fund Balance with Treasury. The Navy statements did not disclose in Note 2, Fund Balance with Treasury, $1.8 billion in FY 1991 expiring year funds that were returned to the Treasury on September 30, 1996. SFFAS No. 1 requires that the Agency "provide information on unused funds in expired appropriations that are returned to the Treasury at the end of a fiscal year." In addition, the DFAS Cleveland Center miscalculated by $1.5 million the amount for the restricted unobligated balance in Note 2. The inclusion of an erroneous amount for appropriation 0703 - Family Housing, Navy and Marine Corps, caused the amount reported in the Fund Balance with Treasury to be overstated by $1.5 million.

In addition, Note 2 did not disclose that $2.2 billion of Closed Appropriation balances that were no longer available for disbursement or to pay liabilities was included in the obligated (but not expensed) amount of $48.1 billion. This situation occurred because adequate guidance regarding the footnote disclosure

of Closed Appropriation balances had not been developed. The Closed Appropriations were reopened at the Treasury level for the recording of accounting adjustments in FY 1996. OMB Bulletin 94-01 defines Fund Balance with Treasury as the "amount of the entity's accounts with the U.S. Treasury for which the entity is authorized to make expenditures and pay liabilities." This guidance does not indicate how to disclose an obligated balance associated with closed years that is no longer available for expenditure or for payment of liabilities. As a result, the amount of Fund Balance with Treasury available for expenditure as reported in the financial statements could be misleading.

Reopened Closed Appropriations. The DFAS Cleveland Center inaccurately calculated and disclosed the amounts related to the Closed Appropriations in Note 3 1. The DFAS Cleveland Center attempted to comply with full disclosure of the effect of the reopening of the Closed Appropriations on the financial statements. However, errors totalling $540.1 million occurred in the calculation of the line items in Note 31 because amounts related to Marine Corps appropriations were excluded from the calculation. The exclusion resulted in an understatement of assets, liabilities, and equity associated with the reopened Closed Appropriations by $540.1 million. This error was limited to the footnote and did not affect the amount reported in the Statement of Financial Position. Table 2 identifies the effect of excluding the amounts related to the Marine Corps from Note 3 1.

Table 2. Amounts Excluded from Note 31

Footnote Line Item	Amount Excluded (millions)
Fund Balance with Treasury	$531.1
Accounts Receivable	0.6
Advances and Prepayments	8.4
Subtotal Assets	**$540.1**
Accounts Payable	349.4
Other Liabilities and Net Position	190.7
Subtotal Liabilities and Equity	**$540.1**

Problem Disbursements. The Navy's disclosure of Problem Disbursement information in Note 31 was inaccurate and could lead to the misinterpretation of Problem Disbursement data in the FY 1997 Navy General Fund financial statements. This situation occurred because In-Transit Problem Disbursements

identified by the Assistant Secretary of the Navy (Financial Management and Comptroller) at the end of FY 1996 and included in Note 31 amounts were categorized as either Unmatched Disbursements or Negative Unliquidated Obligations. Therefore, the ending balances disclosed for the categories of Unmatched Disbursements and Negative Unliquidated Obligations were overstated by an amount related to In-Transit Problem Disbursements.

Guidance from DFAS Headquarters requires that the Problem Disbursement categories of Negative Unliquidated Obligation and Unmatched Disbursements be disclosed in Note 31 to compare with prior-year Problem Disbursement balances as a vehicle for tracking progress in the reduction of Problem Disbursements. To consistently track progress, a category entitled In-Transit Problem Disbursements should be included in Note 31 to the FY 1997 Navy General Fund financial statements. Additionally, FY 1996 ending Problem Disbursement balances for the Unmatched Disbursement and Negative Unliquidated Obligation categories should be adjusted accordingly. Disclosure in this manner will prevent an inconsistent disclosure in the FY 1997 financial statements.

Summary

The completion of the first consolidated Navy General Fund financial statement was a major effort. However, until system improvements are made and audit trails are established to allow for verification of field-level data, the Navy risks material misstatement in its financial statements. The DFAS Centers were aware of deficiencies caused by noncompliant accounting systems and were in the process of implementing an interim migratory accounting system strategy. Therefore, we have not made recommendations in this area. In the meantime, controls over the transfer of accounting data from field-level accounting systems require increased attention. The audit trails or crosswalks between field-level accounting systems and the departmental systems need to be documented and tested. Otherwise, the Navy risks not being able to trace the accounting for approximately $71 billion of financial assets being reported through financial systems. Also, until historical data for $1.9 billion of Accounts Receivable for all appropriations can be captured and reported through an accounting system, each account must be researched to determine an appropriate basis for estimating uncollectible receivables. According to the SFFAS Number 1, losses due to uncollectible amounts should be measured through a systemic methodology based on analysis of both individual accounts and a group of accounts as a whole. In addition, the Under Secretary of Defense (Comptroller) should provide supplemental guidance to DFAS Centers for reporting and financial disclosure to ensure consistent and accurate presentation of financial

data related to Accounts Receivable, Inventory, OM&S, Fund Balance with Treasury, and Problem Disbursements.

Assistant Secretary of the Navy (Financial Management and Comptroller) Comments on the Finding

The Assistant Secretary of the Navy (Financial Management and Comptroller) nonconcurred with the finding, stating that the Office of Financial Operations was responsible for compiling and forwarding the data for Inventory, Net to the DFAS Cleveland. Therefore, additional guidance for reporting and disclosure of Inventory, Net was not necessary. Concerning the disclosure for Inventory, Net (Note 8), the Assistant Secretary stated that except for a small trust fund, the General Funds inventory was either held for future use or held as war reserve materiel. The disclosure presented in the DoD form and content guidance conforms to reporting Working Capital Fund inventory, not General Funds. The Assistant Secretary also requested revision of Appendix D with updated information on Navy accounts.

Audit Response

We do not agree with the comments of the Assistant Secretary. Additional guidance was needed to accurately classify Inventory, Net in accordance with the OMB form and content guidance. Inventory, Net was derived primarily from amounts reported in the Supply System Inventory Report, which included $40.4 billion of principal items and $1 .O billion of secondary items. The Office of Financial Operations did not provide the guidance needed to accurately classify the principal items as either Inventory Held for Future Sale or War Reserve Materiel. The Naval Audit Service reported that missile and munition inventories, valued at $34.1 billion, were held as War Reserve Materiel but reported as Inventory Held for Future Sale. Additionally, the Supply System Inventory Report guidance that could have been used to accurately classify the secondary item inventory as Inventory Held for Current Sale, Held for Future Sale, War Reserve Materiel, and Excess, Obsolete, and Unserviceable materiel was not followed. DoD 7000.14-R, the "DoD Financial Management Regulation," volume 6, “Reporting Policies and Procedures,” chapter 6, “Form and Content of Audited Financial Statement,” January 1998, significantly revised the reporting and disclosure for the materiel that was previously classified as Inventory.

data related to Accounts Receivable, Inventory, OM&S, Fund Balance with Treasury, and Problem Disbursements.

Assistant Secretary of the Navy (Financial Management and Comptroller) Comments on the Finding

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Audit Response

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We revised Appendix D to include the information requested.

Recommendations and Management Comments

1. We recommend that the Director, Defense Finance and Accounting Service, require the Defense Finance and Accounting Service Cleveland and Kansas City Centers to establish audit trails that trace financial data by documenting and testing crosswalks between all nonstandard general ledger financial accounting systems and departmental accounting systems.

Management Comments. The DFAS concurred, stating that the DFAS Cleveland Center completed crosswalks between the Navy Departmental System (NHFS) and both the STARS Headquarters Claimant Module and STARS Claimant Accounting Module in April 1997 and that crosswalks between the Responsible Office Accounting and Reporting System and NHFS are nearly complete. The DFAS Kansas City Center plans to implement the Standard Accounting Budgeting and Reporting System 2, Phase II, in October 1998. Completion of Phase II will provide audit trails for all Marine Corps General Fund Appropriations.

2. **We recommend that the Director, Defense Finance and Accounting Service, require that Defense Finance and Accounting Service Cleveland Center:**

a. Establish a systemic methodology for determining allowances for uncollectible Accounts Receivable based on research of past losses.

Management Comments. The DFAS concurred, stating that the DFAS Cleveland Center is currently working to improve procedures related to vendor duplicate, erroneous, and over payments in the One Pay System, which will include a process to estimate the allowance for losses on claims and refunds receivable. Because the Department of the Navy is responsible for determining the allowances to be applied to accounts receivable outside the One Pay System and for reporting the amount to DFAS, the Navy and DFAS will continue to coordinate procedures to maintain and establish a systemic methodology. DFAS plans to complete the action by June 30, 1998.

b. Establish written procedures that require supervisory review and approval of amounts reported in the Notes to the financial statements to ensure compliance with the Statement of Federal Financial Accounting Standards and Office of Management and Budget Bulletin No. 94-01,

"Form and Content of Agency Financial Statements," for adequate footnote disclosure.

Management Comments. The DFAS concurred, stating that a draft of the DoD Financial Management Regulation that covers standard Chief Financial reporting is being staffed. Additionally, DFAS Centers will be responsible for drafting standard operating procedures to ensure that supervisory personnel conduct a more comprehensive and detailed review of each footnote to include the information to be disclosed, the extent of disclosure, and the approval process for adjustments. In the interim, the DFAS Cleveland Center will draft written procedures that require supervisory review and approval of footnote information by January 31, 1998.

c. Reclassify and separately disclose in the footnotes, the amount of FY 1996 In-Transit Problem Disbursements included in Unmatched and Negative Unliquidated Obligation Problem Disbursement amounts in Note 31 to the FY 1997 Navy General Fund financial statements.

Management Comments. The DFAS concurred, stating that the DFAS Cleveland Center will include the recommended disclosure in the FY 1997 CFO statements. DFAS plans to complete the action by December 31, 1997.

3. **We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) provide the Defense Finance and Accounting Service Cleveland Center with guidance for the reporting and disclosure of FY 1997 Inventory, Net.**

Management Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred, indicating that the FY 1997 Department of the Navy financial statements, they will be prepared using the DoD "Guidance on Form and Content," as presented in the DoD Financial Management Regulation. The Assistant Secretary of the Navy (Financial Management and Comptroller) plans to complete the action by March 1, 1998.

4. **We recommend that the Office of the Under Secretary of Defense (Comptroller):**

a. Provide the Defense Finance and Accounting Service with specific guidance regarding the reporting of Operating Materials and Supplies in accordance with the intent of the Federal Accounting Standards Advisory Board.

b. Provide the Defense Finance and Accounting Service with specific guidance on the disclosure in the footnotes to the financial statements of amounts included in Fund Balance with Treasury related to Closed Appropriations.

Management Comments. The Under Secretary of Defense (Comptroller) did not comment on a draft of this report. We request that the Under Secretary provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope and Methodology

Work Performed. We examined the DFAS Cleveland and Kansas City Centers' processes for consolidating the financial data used to produce the FY 1996 Navy General Fund financial statements. The DFAS Centers consolidated field-level data, which were used to prepare the Navy General Fund financial statements, version 2, submitted to us on December 17, 1996. We tested the process for crosswalking computer-generated trial balances to the claimant-level financial statements. This testing was completed at the claimant by appropriation level. We also tested the consolidation of appropriation-level financial statements. Using a summary of financial statement line item data by appropriation, we verified the accuracy of consolidating appropriation-level data to the consolidated Navy financial statements. Further, we reviewed 15 off-line adjustments totaling $276.1 billion made to the version 2 financial statements and all variances between version 2 and the final version of the Navy's financial statements for accuracy and completeness.

Limitations to Audit Scope. We did not evaluate the accuracy of data from sources outside the DFAS Cleveland and Kansas City Centers, including the accuracy of data submitted by field-level accounting entities. We did not review the compilation of the Navy Defense Business Operations Fund financial statements because the final version of the statements was not issued by the Department of the Navy and DFAS Cleveland Center in time to perform the audit field work.

Audit Period and Standards. We performed this financial-related audit from May 1996 through August 1997. The audit was performed in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD. We evaluated whether significant control policies and procedures had been properly designed and were operating effectively, and we included tests of management controls considered necessary.

Use of Computer-Processed Data. To achieve the audit objectives concerning the manual process for preparing the FY 1996 Navy General Fund financial statements, we relied on computer-processed data from numerous accounting systems. We did not test the reliability of the data from the accounting systems because we focused on the processes used to prepare financial statements. However, various audits by the Naval Audit Service tested the reliability of the data and identified inaccuracies. For example, the amounts reported for the

Fund Balance with Treasury were not accurate. The DFAS Cleveland and Kansas City Centers manually computed the Fund Balance with Treasury balance because the accounting records did not reconcile with the Treasury reported balance. Also inaccuracies were noted in the data reported from the Supply System Inventory Report. About $20.4 billion of ammunition data was omitted and about $11.6 billion was improperly included. These data inaccuracies do not change the conclusions reached in this report.

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

Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls over its operations and to perform periodic self-evaluations of those management controls. We reviewed both elements of the DFAS Cleveland and Kansas City Centers management control program.

Scope of Review of the Management Control Program. We reviewed the adequacy of the DFAS Cleveland and Kansas City Centers management controls over the compilation of the FY 1996 Navy General Fund Consolidated Financial Statements. Specifically, we reviewed management controls over adjustments and compilation of the financial statements. We also reviewed management's self-evaluation program as applicable to those controls.

Adequacy of Management Controls. We identified material management control weaknesses as defined by DoD Directive 5010.38. The DFAS Cleveland and Kansas City Centers had not established effective controls to ensure that field-level accounting data were accurately crosswalked to the departmental accounting system. In addition, procedures were not in place to accurately estimate the allowance for uncollectible Accounts Receivable. The recommendations, if implemented, will correct the material weaknesses. Recommendation 1., if implemented, will improve the DFAS Centers' crosswalked data. Recommendation 2.a. will improve the accuracy of uncollectible accounts receivable reported on the financial statements. Recommendations 2.b. and 2.c. will facilitate adequate footnote disclosure of financial information by the DFAS Cleveland Center. We will provide a copy of this report to the senior official in charge of management controls in the Office of the Secretary of Defense and the DFAS.

Adequacy of Management's Self-Evaluation. The DFAS Cleveland Center management self-evaluation was inadequate. The DFAS Cleveland Center had

established assessable units related to the general accounting processes affecting the preparation of the financial statements and had planned reviews to assess those areas under the internal management control program. However, the reviews were not completed. During FY 1996, the DFAS Cleveland Center completed 34 of 56 (61 percent) of the planned reviews of assessable units. Not completing planned assessable unit reviews limits the effectiveness of the internal management control program.

The DFAS Cleveland Center also had not accurately documented accounting system deficiencies in management reports; therefore, the Center had not implemented alternative controls to mitigate accounting system deficiencies until the accounting systems are improved. The management reports on individual accounting systems did not show that the audit trails between field-level and departmental accounting systems did not exist. Although the System Manager/User Review for the STARS reported that the STARS does not establish an allowance for uncollectible Accounts Receivable and corresponding expense to provide full financial disclosure and that STARS field-level reimbursable accounting function does not "age" receivables, the DFAS Cleveland Center had not established effective alternative procedures to accurately estimate the allowance.

The DFAS Kansas City Center had not designated the processes the Center used to compile the financial reports as a separate assessable unit in FY 1996. The Center indicated that the process would become a separate assessable unit by June 1997. In addition, due to the consolidation of accounting functions, some of the planned FY 1996 reviews that were not completed were no longer valid and the internal management control program was not updated to reflect the changes. The DFAS Kansas City Center planned to update the assessable units in FY 1997, accordingly we are making no recommendations.

Adequacy of Management's Assessment of Accounting Systems. The DFAS Cleveland and Kansas City Centers reported that the accounting systems used to prepare the CFO financial statements did not comply with the Key Accounting Requirements in their Annual Statements of Assurance for FY 1996.

The DFAS Cleveland Center System Manager/User Review of the STARS indicated that the system satisfied the Key Accounting Requirement for audit trails. While the provision for audit trails within the STARS may be effective, the audit trails between STARS claimant-level accounting systems and the Navy Headquarters Financial System were not. The DFAS Cleveland Center did not document and test the automated crosswalks to convert the field-level accounting data to the general ledger used by the STARS.

The DFAS Kansas City Center System Manager/User Review of the Standard Accounting Budgeting Reporting System indicated that the system generally complied with the Key Accounting Requirements but that it was not a complete

financial management system. The system was not used to satisfy CFO reporting requirements, does not interface with inventory and property accounting systems, and was not programmed to age Accounts Receivable.

Appendix B. Summary of Prior Coverage

General Accounting Office

GAO Report No. AIMD-96-7, "CFO Act Financial Audits - Increased Attention Must Be Given to Preparing Navy Financial Reports," March 1996 (OSD Case No. 1050). This report states that the Navy FY 1994 financial statements were substantially inaccurate. Specifically, GAO found $225 billion of errors in the statements, to include $66 billion of material omissions and $43 billion of misrecorded items. The Navy statements also omitted amounts for the building of aircraft and the modernization of weapon systems. A root cause of the Navy reporting deficiencies was the lack of internal controls and disciplined financial operations.

GAO recommended that the DoD Comptroller and the Assistant Secretary of the Navy (Financial Management and Comptroller) jointly act to produce auditable financial statements for the Navy beginning in FY 1996 and periodically report results to the Secretary of Defense. The recommendations focused on compiling financial statements in accordance with guidance, implementing basic internal controls over financial accounting, and implementing strategies for the production of reliable statements by FY 1996. The Office of the Under Secretary of Defense generally concurred with the GAO's findings and recommendations.

Department of Defense, Inspector General

IG, DoD, Report No. 97-100, "Asset Presentation on Military Department General Fund Financial Statements," February 25, 1997. This report states that the DFAS Centers incorrectly and inconsistently presented assets on the FYs 1994 and 1995 Army and Air Force General Fund financial statements. Specifically, $3 1.3 billion of Army war reserves and an incalculable amount for Air Force war reserves were not adequately disclosed. Also, $10.5 billion in progress payments were not adequately disclosed. To correct these problems, the report recommended that the Under Secretary of Defense (Comptroller) clarify the accounting guidance for reporting war reserves and progress payments on the financial statements, include war reserves as a separate line item on the financial statements, and consistently present progress payments by the DFAS Centers. The Under Secretary of Defense (Comptroller) nonconcurred with the recommendations, but subsequently agreed to follow the FASAB guidance for the FY 1998 Financial Statement reporting cycle. Where guidance is not explicit, the Comptroller plans to seek resolution of the issue with the Accounting and Auditing Policy Committee.

IG, DoD, Report No. 97-027, "Defense Finance and Accounting Service Work on the Navy Defense Business Operations Fund FY 1995 Financial Statements," November 22, 1996. This report states that the DFAS Cleveland Center did not have the required controls over processes used to compile the financial statements to ensure that errors do not occur. Specifically, standard written procedures were not in place for entering adjustments to the financial data; controls were not established for the manual input of financial statement data; and the Center published inaccurate line-item crosswalks for financial data. The IG, DoD, recommended that the Director, DFAS, require DFAS Cleveland Center to establish written procedures for adjusting financial reports in accordance with DoD 7000.14-R; establish an automated process for transferring financial statement data to a spreadsheet; correct errors in published crosswalks; and establish procedures for updating the crosswalks. The Director, DFAS, concurred and initiated corrective action.

Naval Audit Service

NAS Report No. 044-95, "Fiscal Year 1994 Consolidating Financial Statements of the Department of the Navy DBOF," May 30, 1995. The report, at the request of the IG, DoD, did not issue an opinion on the Statement of Financial Position of the FY 1994 Department of the Navy DBOF Consolidating Financial Statements. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, gave the IG, DoD, overall responsibility for auditing DBOF financial statements. The NAS audit supported this requirement. The NAS reported that the DFAS paying offices inappropriately estimated collections and disbursements for nonreporting activities. In addition, DFAS improperly estimated sales for activities and ships. The DFAS Cleveland Center concurred or concurred in principle with the recommendations related to its work and made adjustments.

Appendix C. FY 1997 Beginning Balances

The Navy was not required to prepare General Fund financial statements for FY 1995; therefore, the DFAS Cleveland Center did not present data from FY 1995 for comparative purposes on the FY 1996 financial statements. Our audit determined that financial statement data could not be traced back through the accounting systems, and the accounting systems used for consolidating and reporting the financial statement data did not comply with the Key Accounting Requirements. Additionally, NAS was unable to give an opinion on the Statement of Financial Position, primarily because of inadequate financial systems and incomplete and unauditable supporting records. (For details, see "Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Auditor's Opinion," March 1, 1997.) Consequently, it cannot be determined whether FY 1996 ending balances are supportable for use as beginning balances for FY 1997 financial statements.

Appendix D. Navy General Funds

Entity Accounts

General Funds

0380 Coastal Defense Augmentation, Navy
0703 Family Housing, Navy and Marine Corps
1105 Military Personnel, Marine Corps
1106 Operation and Maintenance, Marine Corps
1107 Operation and Maintenance, Marine Corps Reserve
1108 Reserve Personnel, Marine Corps
1109 Procurement, Marine Corps
1205 Military Construction, Navy
1235 Military Construction, Navy Reserve
1236 Payments to Kaho'Olawe Island Conveyance, Remediation, and Environmental Restoration Fund, Navy
1319 Research, Development, Test and Evaluation, Navy
1405 Reserve Personnel, Navy
1453 Military Personnel, Navy
1506 Aircraft Procurement, Navy
1507 Weapons Procurement, Navy
1508 Procurement of Ammunition, Navy and Marine Corps
1611 Shipbuilding and Conversion, Navy
1804 Operation and Maintenance, Navy
1806 Operation and Maintenance, Navy Reserve
1810 Other Procurement, Navy
3980 Navy Management Fund

Revolving Funds

4557 National Defense Sealift Fund, Navy

Trust Funds

8008 Office of Naval Records and History Fund
8423 Midshipmen's Store, Unites States Naval Academy
8716 Department of the Navy General Gift Fund
8723 Ship's Stores Profits, the Navy
8730 United States Naval Academy Museum Fund
8733 United States Naval Academy General Gift Fund

Special Funds

5095 Wildlife Conservation, etc., Military Reservations, Navy
5185 Kaho'Olawe Trust (Special) Conveyance, Remediation, and Environmental Restoration Fund, Navy

Non Entity Accounts

Special Funds (Receipt Accounts)

- 3041 Recoveries Under the Foreign Military Sales Programs
- 3210 General Fund Proprietary Receipts, Defense Military, Not Otherwise Classified
- 3875 Budget Clearing Account (Suspense)
- 3878 Budget Clearing Account (Deposits)
- 3879 Undistributed Letter of Credit Differences (Suspense)
- 3880 Unavailable Check Cancellations and Overpayments (Suspense)

Special Funds

- 3885 Undistributed Intra-Governmental Payments, Navy
- 9082 Intra-Budgetary Transactions - Trust Funds National Defense

Deposit Funds

- 6001 Proceeds of Sales of Lost, Abandoned, or Unclaimed Personal Property, Navy
- 6002 Personal Funds of Deceased, Mentally Incompetent, or Missing Personnel, Navy
- 6025 Pay of the Navy, Deposit Fund
- 6026 Pay of the Marine Corps, Deposit Fund
- 6050 Employees Payroll Allotment Accounts (U.S. Bonds)
- 6075 Withheld Allotment of Compensation for Payment of Employee Organization Dues, Navy
- 6083 Withheld Allotment of Compensation From Charitable Contributions, Navy
- 6134 Amounts Withheld for Civilian Pay Allotments, Navy
- 6275 Withheld State and Local Taxes
- 6434 Servicemen's Group Life Insurance Fund, Suspense, Navy
- 6705 Civilian Employee Allotment Account, Navy
- 6706 Commercial Communication Service, Navy
- 6763 Gains and Deficiencies on Exchange Transactions, Navy
- 6850 Housing Rentals, Navy
- 6875 Suspense
- 6999 Accounts Payable, Check Issue Underdrafts, Navy

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
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, Cleveland Center
  Director, Defense Finance and Accounting Service, Kansas City 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

Part III - Management Comments

Assistant Secretary of the Navy (Financial Management and Comptroller) Comments

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D.C.20350-1000

NOV 06 1997

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Subj: DRAFT AUDIT REPORT ON DEFENSE FINANCE AND ACCOUNTING SERVICE WORK ON THE NAVY GENERAL FUND FISCAL YEAR 1996 FINANCIAL STATEMENTS (PROJECT NUMBER 6FI-2024)

Ref: (a) DODIG memo of 11 Sep 97

Encl: (1) Response to Findings and Recommendations
(2) List of Department of the Navy Accounts, Entity/Non-Entity by Type of Fund

By reference (a), you provided a copy of the subject draft audit report for our review and comment. Enclosure (1) provides our response to the findings and recommendations.

Enclosure (2) provides a list of the Department of the Navy (DON) accounts, entity/non-entity by type of fund extracted from the DON Fiscal Year 1996 Annual Financial Report. We suggest that you replace Appendix D of the subject audit with enclosure (2). This enclosure was based upon the Department of Defense "Guidance on Form and Content" and "Supplement to Volume I, Treasury Financial Manual" and more accurately reflects the classification and fund type used to prepare the DON Principal Statements.

My point of contact for this audit is Mr. Warren Pfeiffer, FMO-225. He may be reached at (202) 685-6730, DSN 325-6730 or e-mail, pfeiffer-warren@fmogw.dipcw.disa.mil.

Deborah P. Christie

DEBORAH P. CHRISTIE
Assistant Secretary of the Navy
(Financial Management and Comptroller)

copy to:
NAVINSGEN (02)
DFAS-HQ
DFAS-CL

RESPONSE TO FINDINGS AND RECOMMENDATIONS
DODIG DRAFT AUDIT REPORT
PROJECT NUMBER 6FI-2024

Finding, Inventory, Net: Reporting guidance provided to the Defense Finance and Accounting Service (DFAS) Cleveland (CL) and Kansas City Centers was not consistent with SFFAS. Specifically, the guidance for reporting Inventory was inadequate and resulted in inconsistent and incomplete disclosure of financial information in the Notes to the Financial Statements.

Response: Nonconcur. To provide for uniformity and consistency in preparing and presenting the Principal Statements and Notes, the Under Secretary of Defense (Comptroller) (USD(C)) issues to the services and Department of Defense (DOD) agencies DOD "Guidance On Form and Content." As the "Form and Content" states, the guidelines set out disclosure requirements for the financial statements. As directed, the Department of the Navy (DON) used the DOD "Form and Content" to prepare and present the DON Fiscal Year (FY) 1996 Principal Statements and Notes. The data for Inventory, Net was a data call item and the data was taken from the DOD Supply System Inventory Report. The DON, Office of Financial Operations (FMO) was responsible for compiling and forwarding that data to the DFAS-CL. Since FMO forwarded the data for Inventory, Net (Note 8) to DFAS-CL, for inclusion in the Principal Statements, additional guidance to DFAS-CL for reporting and disclosure of Inventory, Net was not necessary.

Inventory funded by General Funds, Index 17 is either held for future use or as war reserve materiel, not inventory held for sale, except for a small amount in a trust fund. The disclosure presented in the "Form and Content" conforms more with reporting for the Working Capital Fund business areas, not general funds. Per informal USD(C) guidance the most reasonable categories for reporting Inventory, Net (Note 8) would be the stratification: Held in Reserve for Future Sale and War Reserve Material.

Recommendation 3: We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) provide the DFAS-CL with guidance for the reporting and disclosure of FY 1997 Inventory, Net.

Enclosure (1)

Response: Concur. In preparing and presenting the FY 1997 DON Principal Statements and Notes, we will use the DOD "Guidance on Form and Content", as presented in the DOD Financial Management Regulation, Volume 6, Chapter 6. As we work with DFAS-CL Center in preparing and presenting the DON FY 1991 Principal Statements and Notes we will make every effort to ensure that both of our organizations follow the appropriate guidance. This corrective action should be accomplished by 1 March 1998.

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List of

Department of the Navy Accounts,

Entity/Non-Entity

By Type of **Fund***

*Taken from Note 1. Summarv of Significant Accounting Policies, Department of the Navy Financial Year 1996 Annual Financial Report, pages 56-57.

Enclosure (2)

Footnotes

The accounts used to prepare the principal statements are classified as entity/non-entity and by type of fund. Entity accounts consist of resources that the agency has the authority to decide how to use, or where management is legally obligated to use funds to meet entity obligations. Non-entity accounts are assets that are held by an entity but are not available for use in operations.

Entity Accounts:

General funds

17X0380	Coastal Defense Augmentation, Navy
17 0380	Coastal Defense Augmentation, Navy, (fiscal year)
17 0703	Family Housing, Navy and Marine Corps (fiscal year)
17 1105	Military Personnel, Marine Corps (fiscal year)
17 1106	Operation and Maintenance, Marine Corps (fiscal year)
17 1107	Operation and Maintenance, Marine Corps Reserve (fiscal year)
17 1108	Reserve Personnel, Marine Corps (fiscal year)
17 1109	Procurement, Marine Corps (fiscal year)
17 1205	Military Construction, Navy (fiscal year)
17 1235	Military Construction, Naval Reserve (fiscal year)
17X1236	Payments to Kaho'Olawe Island Conveyance, Remediation. and Environmental Restoration Fund, Navy
17x1319	Research, Development, Test and Evaluation, Navy
17 1319	Research, Development, Test, and Evaluation, Navy (fiscal year)
17 1405	Reserve Personnel, Navy (fiscal year)
17 1453	Military Personnel, Navy (fiscal year)
17 1506	Aircraft Procurement, Navy (fiscal year)
17 1507	Weapons Procurement, Navy (fiscal year)
17 1508	Procurement of Ammunition, Navy and Marine Corps (fiscal year)
17X1611	Shipbuilding and Conversion, Navy
17 1611	Shipbuilding and Conversion, Navy (fiscal year)
17 1804	Operation and Maintenance, Navy (fiscal year)
17 1806	Operation and Maintenance, Navy Reserve (fiscal year)
17 1810	Other Procurement, Navy (fiscal year)
17X3980	Navy Management Fund

Revolving funds

17x4557	National Defense Sealift fund, Navy
17 4557	National Defense Sealift Fund. Navy (fiscal year)

Trust funds

17X8008	Office of Naval Records and History fund
17X8423	Midshipmen's Store, United States Naval Academy
17X8716	Department of the Navy General Gift Fund
17X8723	Ship's Stores Profits, the Navy
17X8730	United States Naval Academy Museum Fund

Footnotes

Trust **Funds** (cont'd)

17X8733	**United States Naval** Academy General Gift Fund

Special fund5

17x5095	Wildlife Conservation, etc., Military Reservations, Navy
17X5185	**Kaho'Olawe** Island Conveyance, Remediation, and **Environmental** Restoration fund, Navy

Non Entity Accounts

Special funds (Receipt Accounts)

17 3041	Recoveries under the Foreign Military Sales Programs
17 3210	General Fund proprietary Receipts, Defense Military, Nor: Otherwise Classified
17F3875	Budget Clearing Account (Suspense)
17F3878	Budget Clearing Account (Deposits)
17F3879	Undistributed and Letter of Credit Differences (Suspense)
17F3880	Unavailable Check Cancellations and Overpayments (Suspense)

Special funds

17X3885	Undistributed Intra-Governmental Payments, Navy
17X9082	Intra-Budgetary Transactions-Trust Funds National Defense

Deposit funds

17X6001	Proceeds of Sales of Lost, Abandoned, or Unclaimed Personal Property. Navy
17X6002	Personal **funds** of Dcccased, Mentally **Incompetent** or Missing Personnel, Navy
17X6025	Pay of the Navy, Deposit Fund
17X6026	Pay of the Marine Corps, Deposit Fund
17X6050	Employees Payroll **Allotment** Accounts (U.S. Bonds)
17X6075	Withheld Allotment of Compensation for payment of Employee Organization dues, Navy
17X6083	Withheld Allotment of compensation from Charitable Contributions Navy
17X6134	Amounts **Withheld** for Civilian Pay Allotments, **Navy**
17X6275	Withheld State and Local Taxes
17x6434	Servicemen's Group Life Insurance Fund, Suspense, Navy
17X6705	Civilian Employees Allotments Account. Navy
17X6706	Commercial Communication Service, **Navy**
17X6763	Gains and Deficiencies on Exchange Transactions, Navy (fiscal **year)**
17X6850	Housing Rentals, Navy
17X6875	Suspense
17X6999	Accounts Payable, Check Issue **Underdrafts**, Navy

Defense Finance and Accounting Service Comments

DEFENSE FINANCE AND ACCOUNTING SERVICE

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DFAS-HQ/AFB

NOV 28 1997

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

SUBJECT: Audit Report on Defense Finance and Accounting Service Work on the Navy General Fund FY 1996 Financial Statements (Project No. 6FI-2024)

Our management comments on the subject report are attached.

The point of contact is Ms. Hettye Kirkland, (703) 607-5104.

Edward A. Harris
Deputy Director for
Accounting

Attachment:
As stated

cc:
DFAS-CL/PI
DFAS-KC/PI
DFAS-IN/PI

SUBJECT: Audit Report on Defense Finance and Accounting Service Work on the Navy General Fund FY 1996 Financial Statements (Project No. 6FI-2024)

RECOMMENDATION 1: That the Director, Defense Finance and Accounting Service, require the DFAS-Cleveland and Kansas City Centers to establish audit trails that trace financial data by documenting and testing crosswalks between all nonstandard general ledger financial accounting systems and departmental accounting systems.

DFAS COMMENTS: Concur. In April 1997, DFAS-Cleveland completed crosswalks among the Navy departmental system, the NHFS, and the Standard Accounting and Reporting System Headquarters Claimant Module (STARS-HCM) and Claimant Accounting Module (STARS-CAM). With the exception of one or two line items, e.g., Unearned Revenues, all lines on the former DD Form 1176, now SF 133, Report on Budget Execution, were successfully reconciled between the departmental and claimant level reports for each Navy claimant. Additionally, crosswalks between the Responsible Office Accounting and Reporting System (ROARS) and NHFS are nearly complete. While these crosswalks demonstrate that audit trails can be established between departmental and claimant level reports, the DFAS does not intend to develop crosswalks for every Navy claimant. Once the STARS-Funds Distribution and Reporting module becomes operational on-line, these crosswalks will be obsolete. Until such time, crosswalks will only be developed if specifically requested by the claimant.

The DFAS-Kansas City Center implemented the Standard Accounting Budgeting and Reporting System 2 (SABRS 2), Phase I, and integrated funds distributions for allotment accounting. SABRS 2, Phase II, is scheduled for implementation in October 1998. This phase will support all general ledger accounting for the Marine Corps in a single, integrated accounting system. SABRS 2 will provide accounting support for all Marine Corps general fund appropriations, comply with all key accounting requirements, and satisfy Chief Financial Officer requirements and any related fiduciary requirements.

For interfacing data sent to SABRS for processing, we have the data format, how the data will be processed in the system, and the general ledger accounts that those transactions will post to. Interfacing transactions are also stored, with the

originating system identification, on the SABRS Transaction History File. These interfacing processes were documented during the System Integration Test Stage. This process establishes audit trails for all Marine Corps General Fund appropriations.

Estimated Completion Date: October 31, 1998.

RECOMMENDATION 2.a. That the Director, Defense Finance and Accounting Service, require the DFAS-Cleveland Center to establish a systemic methodology for determining allowances for uncollectible Accounts Receivable based on research of past losses.

DFAS COMMENTS: Concur. The DFAS agrees that a standard methodology should be established to determine the allowances for uncollectible accounts receivable for the entire Department of the Navy (DON). The DFAS-Cleveland Center is currently working to enhance the business processes related to vendor duplicate, erroneous, and over payments in the One Pay system. Part of the enhanced feature is to process allowances for losses on claims and refunds receivable. However, this initiative is only a portion of the allowances for uncollectibles of all DON accounts receivable. Presently, DON is responsible for determining the allowances to be applied to the remaining position of their accounts receivable and for reporting the amount to DFAS. Both Navy and DFAS will continue to coordinate procedures to maintain and establish a systemic methodology.

Estimated Completion Date: June 30, 1998.

RECOMMENDATION 2. b. That the Director, Defense Finance and Accounting Service, require the DFAS-Cleveland Center to establish written procedures that require supervisory review and approval of amounts reported in the Notes to the financial statements to ensure compliance with the Statement of Federal Financial Accounting Standards and Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," for adequate footnote disclosure.

DFAS COMMENTS: Concur. A draft of the DoD Financial Management Regulation 7000.14 R, Chapter 6, is being staffed to document standard Chief Financial Officer reporting. While the regulation will include instructions previously referenced in the DoD CFO Form and Content for FY 1996, it will also include updated changes. Additionally, each center will be responsible for

drafting standard operating procedures to ensure their supervisory personnel conduct a more comprehensive and detailed review of each footnote. These procedures will include requirements about what information is to be disclosed, the extent of the disclosure, and the approval process for adjustments. In the interim, the DFAS-Cleveland Center will draft written procedures that require supervisory review and approval.

Estimated Completion Date: January 31, 1998.

RECOMMENDATION 2.c. That the Director, Defense Finance and Accounting Service, require the DFAS-Cleveland Center to reclassify and separately disclose in the footnotes, the amount of FY 1996 In-Transit Problem Disbursements included in Unmatched and Negative Unliquidated Obligation Problem Disbursement amounts in Note 31 to the FY 1997 Navy General Fund Financial statements.

DFAS COMMENTS: Concur. The DFAS-Cleveland Center will include a separate disclosure of the applicable disbursements in footnote 31, "Other Disclosures," in the FY 1997 CFO statements.

Eetimated Completion Date: December 31, 1997.

Audit Team Members

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

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