Audit Report

FINANCIAL STATEMENT PRESENTATION
OF DOD PROGRESS PAYMENTS

Report No. 98-139 May 27, 1998

Office of the Inspector General
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Acronyms

AAA	Army Audit Agency
AFAA	Air Force Audit Agency
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
GLAC	General Ledger Account Code
IG	Inspector General
USD(C)	Under Secretary of Defense (Comptroller)

INSPECTOR GENERAL
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May 27, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Audit Report on Financial Statement Presentation of DoD Progress Payments (Report No. 98-139)

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

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Because the Under Secretary of Defense (Comptroller) did not comment on a draft of this report, we request comments on the final report by June 29, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. James L. Kornides, at (614) 751-1400, extension 11, e-mail <JKornides@dodig.osd.mil>, or Mr. Stuart D. Dunnett, at (614) 751-1400, extension 14, e-mail <SDunnett@dodig.osd.mil>. See Appendix C for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-139 **May 27, 1998**
(Project No. 6FJ-2010.01)

Financial Statement Presentation of DoD Progress Payments

Executive Summary

Introduction. Progress payments are a means of providing contract financing for work-in-process expenditures on fixed-price Government contracts with long lead times. Progress payments are designed to alleviate undue strain on a contractor's cash flow and provide interim financing as progress occurs. This is the second in a series of reports resulting from our DoD-wide audit on the financial reporting of DoD progress payments. This report discusses the disclosure of the progress payments DoD organizations made to contractors in FY 1996. The previous report addressed disclosure of the portions of progress payments that were due, but were withheld from contractors pending completion of the contract (contract holdbacks). This audit was performed in conjunction with the Military Department audit agencies.

The Defense Contract Management Command is primarily responsible for administering and approving progress payments on DoD contracts, and the Defense Finance and Accounting Service is responsible for payment. During FY 1996, the Military Departments and the Defense Logistics Agency reported $29.6 billion of progress payments that the Defense Finance and Accounting Service paid to DoD contractors.

During FY 1997, the Defense Business Operations Fund was realigned into several Working Capital Funds. This realignment does not affect the matters discussed in this report.

Audit Objectives. Our audit objective was to determine whether progress payments were accurately shown on the financial statements of the DoD General Fund and the Defense Business Operations Fund for FY 1996.

Audit Results. Due primarily to the lack of clear and timely guidance, the Military Departments and the Defense Logistics Agency materially misstated the $29.6 billion of progress payments reported on the FY 1996 DoD financial statements. The Army and the Navy reported progress payments as Property, Plant, and Equipment, and the Air Force and the Defense Logistics Agency reported progress payments as Advances and Prepayments. Additionally, the data reported by the Navy included purchases of assets with non-progress payment funds, and the Air Force did not include progress payment data on unmatched transactions. The inconsistent reporting of progress payments distorted their presentation in the financial statements. We believe the payments should be

shown consistently by the Military Components in accordance with guidance developed by the Accounting and Auditing Policy Committee. Unless progress payments are consistently and accurately presented, the FY 1998 and future financial statements will also misstate progress payments.

Management did not identify the presentation of progress payments as a material management control weakness. Appendix A describes the management controls assessed and discusses the material management control deficiencies found during the audit.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) implement policy for progress payment reporting in accordance with the guidance from the Office of Management and Budget, and require that the policy be consistently applied.

Management Comments. The Under Secretary of Defense (Comptroller) did not comment on the draft report. Therefore, we request written comments on the final report by June 29, 1998.

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Part I - Audit Results

Audit Background

Progress payments are assets that must be reported on the statements of financial position. Public Law 101-576, the "Chief Financial Officers Act of 1990," requires the annual preparation and audit of financial statements for trust funds, revolving funds, and substantial commercial activities of Executive departments. Public Law 103-356, the "Government Management Reform Act of 1994," requires the preparation and audit of DoD consolidated financial statements for all accounts beginning in FY 1996.

Progress payments provide contract financing for work-in-process expenditures on fixed-price Government contracts with long lead times. Progress payments are designed to alleviate undue strain on a contractor's cash flow and provide interim financing as progress occurs. Contractors use progress payments to finance operating expenses -- such as research and development, purchases of raw materials, special tooling, and test equipment -- instead of obtaining construction loans. Federal Acquisition Regulation 32.503-5 requires that progress payments be supported by the fair value of the work accomplished by the contractor.

Defense Federal Acquisition Regulation Supplement 232.501-1, "Customary Progress Payment Rates," designates a customary DoD progress payment rate of 75 percent of a contractor's cumulative costs. Contractors provide cost data through progress payment invoices that summarize the total costs incurred on a contract as of a specified date. As goods and services are provided, progress payments are liquidated, or recouped, based on the progress payment rate established in the contract. A recoupment is an accounting adjustment from a temporary disbursement account to the account where the obligation is properly recorded. When progress payments are recouped, DoD pays the remaining amount owed minus the prior progress payments.

The Defense Contract Management Command is primarily responsible for administering and approving progress payments on DoD contracts, and the Defense Finance and Accounting Service (DFAS) is responsible for payment. In FY 1996, the DFAS Columbus Center disbursed about $14 billion in non-foreign military sales progress payments to Defense contractors. As of September 30, 1996, the Military Departments and the Defense Logistics Agency (DLA) reported $29.6 billion in unliquidated progress payments.

This is the second in a series of reports resulting from our DoD-wide audit on the financial reporting of DoD progress payments. This report discusses the financial reporting of progress payments that the Military Departments and DLA made to contractors in FY 1996. The previous report addressed the disclosure of portions of the contractor costs that were incurred in FY 1996 but were withheld from contractors pending completion of the contract (contract holdbacks). The Military Department audit organizations assisted us in developing information used in this report.

Audit Objective

The primary objective of our audit was to determine whether progress payments were accurately reflected on the FY 1996 financial statements of the DoD General Fund and the Defense Business Operations Fund (DBOF). We evaluated management controls over the presentation of progress payments (Appendix A). Prior audit coverage is discussed in Appendix B.

Presentation of Progress Payments in the FY 1996 DoD Financial Statements

Due to the lack of clear and timely guidance, the Military Departments and DLA materially misstated the $29.6 billion of progress payments reported on the DoD financial statements. The Army and the Navy reported progress payments as Property, Plant, and Equipment, and the Air Force and DLA reported progress payments as Advances and Prepayments. The Navy also reported data that included non-progress payment purchases of other assets, and the Air Force did not include progress payment data on unmatched transactions.

This condition occurred because:

- the Military Departments and DLA used different accounting guidance to report progress payments in their respective financial statements,
- Department of the Navy accounting systems could not produce complete and reliable information, and
- the Department of the Air Force did not disclose and had not researched about $4.5 billion in unmatched progress payment transactions.

Unless progress payments are consistently and accurately presented, the financial statements for FY 1998 and the future will also misstate progress payments.

Progress Payment Guidance

The Federal Accounting Standards Advisory Board and DoD have issued different accounting guidance for progress payments.

Federal Accounting Standards Advisory Board Guidance. The Federal Accounting Standards Advisory Board issued general guidance on progress payments, but did not indicate where progress payments should be reported on the financial statements. However, the guidance indicated where progress payments for construction projects should not be reported. Statement of Federal Financial Accounting Standard No. 1, "Accounting for Selected Assets and Liabilities," March 30, 1993, stated that Advances and Prepayments do not include progress payments made on long-term contracts, and that progress payments made to a contractor based on the percentage of completion of a contract are not advances and prepayments. However, the guidance did not address progress payments

based on costs incurred by a contractor. Additionally, Standard No. 1 did not state which general ledger account should be used to account for progress payments on the statements of financial position.

DoD Form and Content Guidance. In the "DoD Guidance on Form and Content of Financial Statements for FY 1996 Financial Activity" (DoD Form and Content Guidance), October 1996, the Under Secretary of Defense (Comptroller) (the USD[C]) established DoD accounting policy for progress payments. Chapter 7, "Special Procedures," stated that weapon systems under construction should be valued at the amount of approved progress payments and recorded in a new general ledger account, "Progress Payments Made to Others," General Ledger Account Code (GLAC) 1453. However, the USD(C) stated that the "Progress Payments Made to Others" account should be reported in "Advances and Prepayments" on the DoD General Fund financial statements.

Appendix 3-B of the DoD Form and Content Guidance requires DBOF organizations to report progress payments as Work-in-Process, GLAC 1580.

Progress Payment Reporting

Progress payment accounting data were not accurately or consistently presented on the Military Department and DLA financial statements, were not posted to the appropriate accounting records, and were generally unreliable. The Military Departments and DLA were forced to use conflicting accounting guidance and reported progress payments differently in their financial statements. Also, the Navy did not report an accurate and reliable progress payment balance in its General Fund financial statements, and the Air Force did not disclose the effect of $4.5 billion in unmatched progress payment transactions.

Army. The Army followed the intent of Federal Accounting Standards Advisory Board Standard No. 1 and reported $2.47 billion of progress payments in GLAC 1582, Work-In-Process-Contractor, which matched the Property, Plant, and Equipment line item on the Army General Fund financial statements. The Army had been using this method of reporting and decided not to follow the DoD guidance, which required that progress payments be reported as Advances and Prepayments.

The Army also reported progress payments in its equity and expense accounts. For example, the Army Audit Agency (AAA) reviewed $330.3 million in Army progress payments made during FY 1996 and found that $32.4 million were posted to equity or expense accounts.

The AAA concluded that progress payments were reported inconsistently because the DFAS Indianapolis Center's operating locations and accounting offices did not follow DoD procedures. When the AAA questioned accounting personnel about

the use of expense and equity accounts for posting progress payments, the accounting stations agreed to post them to GLAC 1582, Work-In-Process-Contractor.

The AAA determined that progress payments for the Army Working Capital Fund were appropriately presented on the "Inventory, Net" line item of the financial statements. However, the AAA concluded that the progress payment data used in the Army General Fund FY 1996 financial statements could not be relied on to make management decisions.

Navy. The Navy also generally complied with Federal Accounting Standards Advisory Board Standard No. 1 and did not report progress payments as Advances and Prepayments. Instead, the Navy reported $19.9 billion in progress payments and other assets in the "Property, Plant, and Equipment, Net" line item of the Navy General Fund Statement of Financial Position. However, the reported $19.9 billion in progress payments was inaccurate because it included assets purchased without using progress payments. The Naval Audit Service could not determine how much of the $19.9 billion actually represented progress payments on weapon systems because the supporting data were incomplete and unreliable. The Navy also inconsistently reported $215,000 in progress payments on the "Advances and Prepayments" line item of the Navy General Fund Statement of Financial Position.

Because of the incomplete and unreliable accounting data, the Navy could not retrieve accurate progress payment amounts from its systems. The accounting system used by the DFAS Cleveland Center did not produce complete and reliable information, and a data call on procurement appropriations, made by the Assistant Secretary of the Navy (Financial Management and Comptroller), was ineffective. Details are as follows.

Accounting Data. The Navy Standard Accounting and Reporting System used by DFAS Cleveland Center could not accurately post and summarize progress payment transactions forwarded by the DFAS Columbus Center. For example, progress payments made from the Shipbuilding and Conversion appropriation showed a credit balance of $1.3 billion. Progress payments represent assets and should be debits in the accounting system. Because the credit was inaccurate, progress payment amounts recorded in the Standard Accounting and Reporting System were incomplete and unreliable.

Data Request. Because the Navy accounting system could not produce reliable data, the Navy used a data call to obtain the balance of unliquidated progress payments. The data request identified a balance of $19.9 billion. However, that amount was overstated. The Naval Audit Service reported that the FY 1996 Navy General Fund financial statements included an indeterminable amount of other asset purchases in the $19.9 billion.

Air Force. The Department of the Air Force did not report progress payments in accordance with Federal Accounting Standards Advisory Board Standard No. 1. Instead, the Air Force reported progress payments as Advances and Prepayments, in accordance with the DoD Form and Content Guidance.

The Air Force Audit Agency (AFAA) could not determine the accuracy or reliability of the $7 billion in progress payments reported on the Air Force General Fund Financial Statements. This occurred because the Air Force and DFAS did not research and disclose the effect on the financial statements of about $4.5 billion in unmatched progress payment transactions. Unmatched transactions are held in suspense because payment data do not match the data in the accountable system records.

The AFAA also could not determine the correct account balance for progress payments reported in the FY 1996 Air Force General Fund Consolidated Financial Statements. The AFAA reported that DFAS accounting personnel had not researched progress payment transactions related to $4.2 billion of canceled appropriations. Recoupments represented $3.7 billion of the $4.2 billion in progress payment transactions from canceled appropriations. DFAS personnel stated that the $3.7 billion in progress payment recoupments represented valid transactions, as well as over-recoupments, mismatched transactions, and errors. Also, other unmatched progress payment transactions of $344 million were not researched to determine whether they were valid. Additionally, DFAS Denver Center personnel did not disclose the $4.5 billion of unmatched transactions in the footnotes to the financial statements. These discrepancies significantly affected the accuracy and completeness of the progress payments reported by the Air Force.

DLA. DLA inappropriately reported all $200 million of its progress payments as Advances and Prepayments on the DLA DBOF Consolidated Financial Statements. The DoD Form and Content Guidance requires DBOF activities to report progress payments in the Work-in-Process account because the deliverable items are sold as inventory to DLA customers.

Effect on Financial Statements

Progress payments were not consistently or accurately presented on the DoD financial statements. As a result, $29.6 billion of progress payment data was erroneously summarized in multiple accounts on the statements. Although management was aware of the differences in the disclosures and the problems with the amounts reported, these problems were not adequately disclosed in the footnotes to the financial statements. Inconsistencies and other variations in reported amounts should be disclosed in the footnotes to the financial statements to provide balanced information to users. Improvements are needed to properly consolidate data on progress payment accounting. In addition, the indeterminable amount of other assets included in the $19.9 billion of progress payments reported by the Navy and the $4.5 billion of undisclosed Air Force progress payments could

materially affect the progress payment balances reported by the Navy and the Air Force. This would also affect the accuracy of the DoD Consolidated Financial Statements. Unless progress payment transactions are consistently and accurately presented, progress payments will be misstated on the FY 1998 and future financial statements.

Conclusion

Consistent application of accounting policy for reporting progress payments is needed to ensure the proper consolidation of DoD progress payments on the financial statements and to improve the accuracy of reported progress payment balances. As part of this DoD-wide audit, the Military Department audit organizations made recommendations addressing the weaknesses in their Departments. We are not repeating the recommendations. However, at the time of this audit, the USD(C) and the Inspector General (IG), DoD, were attempting to resolve a disagreement over where progress payment balances should be shown on the financial statements. That disagreement resulted from IG, DoD, Report No. 97-100, "Asset Presentation on Military Department General Fund Financial Statements," February 25, 1997. As a result of mediation, the USD(C) planned to seek resolution of the issue with the Office of Management and Budget, to clarify the guidance on the presentation of progress payments.

Recommendation for Corrective Action

We recommend that the Under Secretary of Defense (Comptroller) implement policy for progress payment reporting in accordance with the guidance from the Office of Management and Budget for presenting progress payments on the Government financial statements, and require that the policy be consistently applied.

Management Comments Required

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

Part II - Additional Information

Appendix A. Audit Process

Scope

The audit was performed by the IG, DoD, and the Military Department audit organizations. We reviewed the FY 1996 Military Department General Fund and DLA DBOF financial statements to determine whether weapon system progress payments were accurately reflected. The DoD Form and Content Guidance requires that weapon system progress payments made with appropriated funds be recorded as Progress Payments Made to Others. The USD(C) has stated that the "Progress Payments Made to Others" account should be summarized as Advances and Prepayments on the DoD financial statements. Appendix 3-B of the DoD Form and Content Guidance requires that DBOF organizations report progress payments as Work-in-Process.

The Military Departments and DLA report progress payments to financial statement accounts such as Advances and Prepayments and Property, Plant, and Equipment. As of September 30, 1996, the Military Departments and DLA reported $29.6 billion in unliquidated progress payments made to Defense contractors. We reviewed progress payments of $29.6 billion to determine whether they were accurately and consistently reported.

Methodology

Audit Period and Standards. This financial audit was conducted from December 1996 through December 1997. The audit was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD. The Military Department audit organizations assisted us in obtaining information. Audit results are based on progress payment balances as of September 30, 1996, as reported by the Military Departments and DLA. We included tests of management controls considered necessary.

Use of Computer-Processed Data. We relied on computer-processed data from the Mechanization of Contract Administration Services System to identify active weapon system contracts with unliquidated progress payment balances. We did not perform a reliability assessment of the computer-processed data. However, on the contracts and documentation that we reviewed, the contract numbers, invoice numbers, disbursement amounts, and disbursement dates generally agreed with the computer-processed data. We did not find errors thatwould preclude the use of computer-processed data in meeting the audit objectives or that would change the conclusions in the report.

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

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 16, 1996, 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 management controls to determine whether progress payments were accurately and consistently reflected on the Military Department and DLA DBOF FY 1996 financial statements. The controls consist primarily of procedures specified in Federal Accounting Standards Advisory Board, Office of Management and Budget, and DoD guidance. We also reviewed management's self-evaluation applicable to those controls.

Adequacy of Management Controls. We identified a material management control weakness as defined by DoD Directive 5010.38, in the Office of the USD(C). Management controls were not adequate to ensure that progress payment transactions were accurately or consistently reflected in the Military Department and DLA financial statements. Implementing our recommendation and those made by the Military Department audit organizations should correct the weakness. A copy of the report will be provided to the senior official responsible for management controls in the Office of the USD(C).

Adequacy of Management's Self-Evaluation. Management officials did not identify the financial statement presentation of progress payments as an assessable unit, and therefore did not identify and report the material management control weakness identified by the audit.

Appendix B. Summary of Prior Coverage

The following audit reports, issued by the IG, DoD, and Military Department audit organizations, addressed the procedures used to record and post progress payments in accountable records and on the DoD financial statements.

IG, DoD, Report No. 98-022, "Reporting of Contract Holdbacks on the DoD Financial Statements," November 17, 1997, states that the Military Department and DLA financial statements did not accurately report payments withheld from contractors in FY 1996 and the work associated with those payments. The Military Departments and DLA recognized about $2.3 billion of holdbacks in the accounts payable line item of the financial statements. The IG, DoD, estimated that an additional $4.9 billion of funds were withheld but not reported. Additionally, payments were withheld for $7.2 billion of work that was not recognized as an asset on the statements of financial position. As a result, assets and liabilities on the Military Department General Fund and DLA DBOF FY 1996 financial statements were understated by $7.2 billion and $4.9 billion, respectively. The report recommends that the USD(C) require the Director, DFAS, to comply with the DoD Form and Content Guidance for accounts payable; revise DoD 7000.14-R, the "DoD Financial Management Regulation;" and calculate contract holdbacks based on unliquidated progress payment balances. Management agreed to address the need to expand the treatment of contract holdbacks with the appropriate authoritative body. However the USD(C) believed that the auditors' recommended treatment should only apply to progress payments based on percentage of completion contracts. The auditors disagreed and believe the recommended treatment should also be applied to progress payments based on contractor cost associated with fixed price contracts. The report is in mediation.

IG, DoD, Report No. 97-100, "Asset Presentation On Military Department General Fund Financial Statements," February 25, 1997, states that the DFAS Centers incorrectly and inconsistently presented $10.5 billion of progress payments on the Army and Air Force FY 1994 and 1995 General Fund Financial Statements. The report recommends that the USD(C) clarify accounting guidance for presenting progress payments on the DoD financial statements. Management nonconcurred with recommendation. However, during mediation, DoD management requested that Office of Management and Budget provide additional DoD progress payment accounting guidance.

AAA Report No. AA 98-17, "Financial Reporting of Progress Payments," November 14, 1997, states that contract holdbacks were materially understated, progress payments were not consistently presented in the accounting records, and disbursements for progress payments made by the DFAS Columbus Center were not always matched with the correct obligations in the accounting records. The report recommended that the DFAS Indianapolis Center modify Army accounting systems to provide for the recording of contract holdbacks, direct accounting offices to use actual progress payment rates when calculating contract holdbacks,

and review trial balances to ensure compliance with the recommended policy. DFAS partially concurred with the recommendations, stating that DoD accounting systems should accurately account for contract holdbacks when a transaction is posted to GLAC 2130, Contract Holdbacks.

Naval Audit Service Report No. 049-97, "Department of the Navy FY 1996 Annual Financial Report: Advances and Prepayments, Non-Federal," September 19, 1997, states that the Navy did not maintain and report accurate figures for "Advances and Prepayments, Non-Federal," and did not have adequate internal controls over those assets. Because of the lack of an integrated accounting system and inadequate data calls, as well as weaknesses in the internal control structure, the "Progress Payments Made to Others" account was understated by an indeterminable amount, because several multiyear appropriations were omitted. The report recommends procedural improvements for obtaining and reporting progress payment amounts in the financial statements. Management concurred with the recommendation and was taking action to obtain and report information.

AFAA Project No. 96053006, "Weapon System Progress Payments, Fiscal Year 1996 Air Force Consolidated Financial Statements," July 3, 1997. This report states that the AFAA could not determine the accuracy of the FY 1996 balance for weapon system progress payments. The AFAA identified $4.5 billion of undisclosed progress payments, and holdbacks of progress payments were understated by $650 million. The report recommends that the DFAS Denver Center provide accountable stations with guidance on reporting unmatched progress payment transactions and unliquidated balances of progress payments and recoupments recorded in canceled appropriations at fiscal year-end. The report also recommends that the DFAS Denver Center disclose the potential impact of unmatched transactions at fiscal year-end in the footnotes to the financial statements, and make adjustments to accurately report progress payment balances in asset and liability accounts. DFAS concurred with the recommendations.

AFAA Project No. 96053010, "Review of Weapon System Progress Payments," October, 1995, states that progress payments for Air Force weapon systems, reported by accountable stations and included on the FY 1995 Air Force consolidated financial statements, were not accurate or reliable. The auditors identified $979.1 million in under- and overstatements of progress payments resulting from unprocessed transactions, unmatched recoupments, and canceled appropriations. The report recommends that DFAS issue accounting guidance for problem transactions and disclose the potential impact of those transactions in the footnotes to the financial statements. DFAS concurred with the recommendations.

IG, DoD, Report No. 92-064, "Titan IV Program," March 31, 1992, states that progress payments for the Titan IV contract were made from a predetermined sequence of appropriations, rather than from the appropriations that reflected the type of work done. As a result, the Air Force did not have adequate internal controls over appropriated funds. Also, U.S.C., title 31, section 1301, and potentially U.S.C., title 31, section 1341, which govern use of appropriated funds, were violated. The report recommends implementation of procedures within DoD to ensure adequate internal controls over appropriations and implementation of controls on the Titan IV contract to properly categorize costs to ensure proper use of appropriated funds. DoD management non-concurred with the recommendations. The funding control issues raised in the "Titan IV Program" audit report are not related to the financial reporting of progress payments finding in this report.

Appendix C. Report Distribution

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