

Audit



Report

THE INVENTORY REVALUATION METHOD AND
GENERAL LEDGER ACCOUNTING TREATMENT
USED IN COMPILING THE FY 1997 AIR FORCE
WORKING CAPITAL FUND FINANCIAL STATEMENTS

Report No. 98-215

September 28, 1998

Office of the Inspector General
Department of Defense

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Acronyms

DFAS	Defense Finance and Accounting Service
EOBR	Excess, Obsolete, or Beyond Repair
GLA	General Ledger Accounts



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September 28, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE DENVER CENTER

SUBJECT. Audit Report on the Inventory Revaluation Method and General Ledger
Accounting Treatment Used in Compiling the FY 1997 Air Force Working
Capital Fund Financial Statements (Report No. 98-215)

We are providing this audit report for review and comments. We performed the audit in response to Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994.

The Director, Defense Finance and Accounting Service Denver Center, did not respond to a draft of this report. DoD Directive 7650.3 requires that all recommendations be resolved promptly. Accordingly, we request that the Director, Defense Finance and Accounting Service Denver Center, provide comments on the final report by October 30, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Brian M. Flynn at (703) 604-9145 (DSN 664-9145, e-mail bflynn@dodig.osd.mil), or Mr. Byron B. Harbert at (303) 676-7405 (DSN 926-7405, e-mail bharbert@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed on the inside back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman".

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-215
(Project No 7FD-2041.02)

September 28, 1998

The Inventory Revaluation Method and General Ledger Accounting Treatment Used in Compiling the FY 1997 Air Force Working Capital Fund Financial Statements

Executive Summary

Introduction. Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires an annual audit of the financial statements of Government operations, trust funds, revolving funds, and commercial activities. This is the second of two reports on this subject area. The first report was Inspector General, DoD, Report No. 98-108, "Inspector General, DoD, Oversight of the Air Force Audit Agency Audit of the FY 1997 Air Force Working Capital Fund Financial Statements," April 7, 1998. The FY 1997 Consolidated Financial Statements of the Air Force Working Capital Fund consist of six activity groups, with total assets of \$28.7 billion and a total net position (Air Force equity) of \$25.7 billion. The Supply Management activity group had total assets of \$25.2 billion and a total net position of \$24.5 billion. The Supply Management activity group's assets included \$24.5 billion of inventory at approximate historical cost.

Audit Objectives. The objective of the audit was to determine whether the Defense Finance and Accounting Service (DFAS) Denver Center consistently and accurately compiled financial data from field activities and other sources for the FY 1997 Air Force Working Capital Fund Financial Statements. We limited our review to the DFAS Denver Center's process for inventory revaluation and the accounting treatment of general ledger accounts in the Air Force Supply Management activity group. See Appendix A for a discussion of the audit scope and methodology and our review of the management control program. See Appendix B for a list of prior audits in this area.

Audit Results. On the FY 1997 Air Force Working Capital Fund Financial Statements, the DFAS Denver Center overstated ending inventory by \$2.7 billion; understated Other Losses by \$956.9 million; understated excess, obsolete, and beyond repair inventory by \$75.5 million; and understated Cost of Goods Sold by \$4.3 million. As a result, account balances for the Inventory, Other Losses, and Cost of Goods Sold were materially misstated in the FY 1997 Air Force Working Capital Fund Financial Statements (Finding A).

The DFAS Denver Center had not identified and documented the accounting effects of 42 general ledger accounts in the Air Force Supply Management activity group. As of September 30, 1997, the 42 general ledger accounts contained recorded balances of

\$159.5 billion. Written definitions, transaction processing guidance, and posting rules did not exist for the 42 general ledger accounts. As a result, neither accountants nor auditors knew what accounting effects resulted from the use of these accounts. In addition, audit trails did not provide the necessary basis for detection and systematic correction of errors, and management had no assurance that the treatment, classification, and reporting of accounting transactions were consistent with the U.S. Government and DoD Standard General Ledgers (Finding B).

See Part I for detailed audit results. Appendix A provides the details of the management control program for the revaluation of inventory for financial statement reporting and the support provided for logistics accounting systems.

Summary of Recommendations. We recommend that the Director, DFAS Denver Center, establish procedures to:

- obtain and use the latest supply stratification reports for calculating excess, obsolete, and beyond repair inventory;
- reduce Other Losses for unrealized holding gains and increase Other Losses for unrealized holding losses when reporting Other Losses related to excess, obsolete, and beyond repair inventory; and
- validate the accuracy of calculations that revalue inventory to approximate historical cost.

We recommend that the Director, DFAS Denver Center, request authority from the Chief Financial Officer, DoD, or the Deputy Chief Financial Officer, DoD, to make prior period adjustments to correct understatements and overstatements. We also recommend that the Director, DFAS Denver Center, direct the Systems and Procedures Directorate to define, document, and provide guidance on posting the 42 general ledger accounts in the Air Force Supply Management activity group.

Management Comments. The Director, Defense Finance and Accounting Service Denver Center, did not comment on the draft report issued on August 31, 1998. We request that the Director, Defense Finance and Accounting Service Denver Center, provide comments on the final report by October 30, 1998.

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Part I - Audit Results

Audit Background

Introduction. Public Law 101-576, the “Chief Financial Officers Act of 1990,” November 15, 1990, as amended by Public Law 103-356, the “Federal Financial Management Act of 1994,” October 13, 1994, requires an annual audit of the financial statements of Government operations, trust funds, revolving funds, and commercial activities. The FY 1997 Consolidated Financial Statements of the Air Force Working Capital Fund consist of six activity groups, with total assets of \$28.7 billion and a total net position (Air Force equity) of \$25.7 billion. The Supply Management activity group had total assets of \$25.2 billion and a total net position of \$24.5 billion. The assets included \$24.5 billion of inventory at approximate historical cost.

Accounting for Inventories. The Statement of Federal Financial Accounting Standards No 3, “Accounting for Inventory and Related Property,” October 27, 1993, permits inventory valuation on the basis of historical cost or latest acquisition cost. Many DoD inventory systems in the Supply Management activity group cannot use the historical cost method. As a result, through FY 1997, most inventory in the Supply Management activity groups in the Military Departments was accounted for at standard price (the selling price). The standard price included both the acquisition cost and surcharges associated with acquiring and holding items in inventory. During FY 1997, the Air Force Supply Management activity group accounted for most inventory at standard price.

For the financial statements, the Defense Finance and Accounting Service (DFAS) Denver Center converted the standard price to the latest acquisition cost and then adjusted the latest acquisition cost to the approximate historical cost. The DFAS Denver Center made this conversion by removing operating cost recovery amounts and, if applicable, inflation amounts that had been added to the latest acquisition cost. When the DFAS Denver Center made additional adjustments to the latest acquisition cost value, this eliminated the unrealized holding gains and losses in allowance accounts¹ and resulted in an approximation of historical cost for reporting on the financial statements. The unrealized holding gains and losses resulted from holding assets in periods of changing prices. With the historical cost method, holding gains or losses are not separately recognized, although they exist.

With the latest acquisition cost method, holding gains or losses are recognized in the valuation of inventory, because the value of inventory is adjusted periodically to present the more current latest acquisition cost. The unrealized holding gains and losses are the net difference between the latest acquisition cost of inventory and its cost basis, whether that difference occurs through purchase, donation,

¹ These allowance accounts are offsetting accounts that decrease the related inventory account balance by the amount of unrealized holding gains and increase the related inventory account balance by the amount of unrealized holding losses in order to determine the approximate historical cost.

customer return, or other accounting event. An upward or downward change in inventory valued at its latest acquisition cost does not, by itself, result in a gain or loss being realized. However, the selling of inventory to another entity results in a gain or loss. As a rule, realized gains and losses should only result from transactions or events with entities other than the entity that holds inventory for sale. An exception to this rule is the requirement to realize a loss on inventory that is declared excess, obsolete, or beyond repair (EOBR). This loss on inventory may be recognized, although the entity inventory may hold the inventory.

Prior Period Adjustments. DoD Regulation 7000.14-R, "DoD Financial Management Regulation," volume 6, "Reporting Policy and Procedures," February 12, 1996, with changes through January 1998, governs by establishing the principles, standards, systems, procedures, and practices necessary to comply with financial management statutory and regulatory requirements. This guidance states that when department-level records have been closed and audited financial statements published, no changes can be made to prior-year line item balances or statement totals without written approval of the Chief Financial Officer, DoD, or the Deputy Chief Financial Officer, DoD.

General Ledger Accounts. Public Law 104-208, the "Federal Financial Management Improvement Act of 1996," September 30, 1996, requires that agency financial management systems comply substantially with Federal requirements for financial management systems, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The DFAS Denver Center has not implemented the U.S. Government and DoD Standard General Ledger account structure for the Air Force Supply Management activity group.

Audit Objectives

The original objective of the audit was to determine whether the DFAS Denver Center consistently and accurately compiled financial data from field activities and other sources for the FY 1997 Air Force Working Capital Fund Financial Statements. We limited our review to the DFAS Denver Center's process for inventory revaluation and the accounting treatment of the general ledger accounts (GLAs) in the Air Force Supply Management activity group. See Appendix A for a discussion of the audit scope and methodology and for our review of the management control program. See Appendix B for a list of prior audits in this area.

Finding A. Inventory Revaluation

On the FY 1997 Air Force Working Capital Fund Financial Statements, the DFAS Denver Center overstated ending inventory by \$2,737.9 million, understated Other Losses by \$956.9 million, understated EOBR Inventory by \$75.5 million, and understated Cost of Goods Sold by \$4.3 million. These misstatements occurred because, in revaluing inventory from standard price to approximate historical cost, the DFAS Denver Center:

- did not obtain or use current data to calculate inventory identified as EOBR,
- did not realize holding losses or reduce holding gains for inventory identified as EOBR,
- made errors in calculating inventory at the latest acquisition cost and inventory identified as EOBR, and
- omitted \$20.5 million of inventory in calculating the amount of realized holding gains to be included in sales.

As a result, the inventory account and other expense account balances were materially misstated in the FY 1997 Air Force Working Capital Fund Financial Statements.

Revaluation Process

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," volume 11B, "Reimbursable Operations, Policy and Procedures-Defense Business Operations Fund," chapter 55, "Supply Management Operations," December 21, 1994, gives the following multistep process for revaluing inventory from standard price to approximate cost:

- Reduce the value of inventory from standard price to latest acquisition cost.
- Calculate the portion of total inventory that is EOBR.
- Revalue EOBR inventory to salvage value.
- Calculate the ratio of unrealized holding gains and losses to the total inventory available for sale.

- Realize losses or reduce holding gains associated with EOBR inventory.
- Realize holding gains and losses associated with sales.

Guidance on Excess, Obsolete, and Beyond Repair Inventory

Supply Stratification Reports. The DoD Financial Management Regulation states that the calculation of inventory that is reported on financial statements as EOBR should be based on percentages obtained from supply stratification reports. These reports compare supply item inventories to requirements and identify the value of:

- items on hand that are potentially excess to requirements, and
- unserviceable items that are not repairable.

The Regulation also states that because the supply stratification reports are prepared semiannually, data from the latest available report will be used until a new report is received.

Net Realizable Value. On August 1, 1997, the Deputy Director for Accounting, DFAS, issued a memorandum to the DFAS Center Directors, “Revised FY 1997 Factors to Adjust Defense Working Capital Funds (DCWF) Supply Management Inventory Values.” The memorandum stated that the net realizable value of inventory identified as EOBR should be 2.7 percent of the latest acquisition cost of the inventory.

Holding Gains and Losses in EOBR Inventory. The DoD Financial Management Regulation states that the difference between the value of the inventory before identification as EOBR and its expected net realizable value after identification shall be recognized as a loss in the current period and reported as Other Losses in the financial statements. When items are moved between the inventory held for sale category and the EOBR category, the allowance accounts for unrealized holding gains and losses are moved with the inventory to the new category. The realized loss for inventory identified as EOBR should not include unrealized holding gains. The DoD Financial Management Regulation does not state that the realized loss for inventory identified as EOBR should include unrealized holding losses. However, reporting EOBR inventory in the financial statements at net realizable value requires including the unrealized holding losses in Other Losses reported. An accountant in the Office of the Under Secretary of Defense (Comptroller) stated that the lack of a requirement to include unrealized holding losses will be corrected in a change to the DoD Financial Management Regulation.

Realized Holding Gains and Losses on Sales. The DoD Financial Management Regulation states that to calculate realized holding gains and losses that are

Finding A. Inventory Revaluation

included in sales, the Cost of Goods Sold at standard price should be multiplied by the ratio of unrealized holding gains and losses to the total inventory available for sale. To determine the profit or loss from sales, these holding gains should then be reduced from Cost of Goods Sold, and realized holding losses should be added to Cost of Goods Sold.

Reported Inventory Value

As of September 30, 1997, for the seven business divisions with inventories within the Air Force Supply Management activity group, \$55.5 billion of inventory was reported at standard price. For financial statement reporting, the DFAS Denver Center revalued this inventory to an approximate historical cost of \$24.5 billion, as shown in Table 1.

<u>Business Division</u>	<u>Standard Price</u>	<u>Approximate Cost</u>
Academy Division	\$ 4.6	\$ 4.5
Fuels Division	55.5	56.4*
General Support Division	1,738.9	1,115.4
Medical - Dental Division	280.5	266.2
Reparable Support Division	52,270.9	21,956.4
Systems Support Division	1,075.8	1,093.8*
Troop Support Division	<u>45.1</u>	<u>37.3</u>
Total	\$55,471.3	\$24,530.0

*Because the accumulated unrealized holding losses were added to the standard price, the approximate cost exceeded the standard price for the Fuels Division and the Systems Support Division.

Tools for Revaluation of Inventory

The DFAS Denver Center used off-line inventory worksheets and personal computer-based spreadsheets to revalue inventory from standard price to approximate historical cost. The off-line inventory worksheets were used to maintain a record of prior and current-year unrealized holding gains and losses for each business division; to calculate the ratio of unrealized holding gains and losses to the total inventory available for sale; to calculate the amount of holding gains

and losses to be realized from sales; and to calculate the valuation of the ending inventory at its approximate historical cost. The spreadsheets were used to reduce inventory from the standard price to the latest acquisition cost and to calculate all amounts related to EOBR inventory.

Revaluation of Inventory

For three of the seven business divisions, the DFAS Denver Center used outdated supply stratification reports or incorrect data to calculate the value of EOBR inventory. In addition, the DFAS Denver Center did not realize holding losses or reduce holding gains related to EOBR inventory; made calculation errors; and did not include all inventory available for sale when calculating the percentage of holding gains to be realized from sales. The result was that in the FY 1997 Air Force Working Capital Fund Financial Statements, ending inventory, valued at approximate historical cost, was overstated by \$2,737.9 million; Other Losses were understated by \$956.9 million; EOBR Inventory was understated by \$75.5 million, and Cost of Goods Sold was understated by \$4.3 million.

General Support Division. The DFAS Denver Center overstated Other Losses by \$57.3 million. Other Losses should have been reported at \$267.6 million instead of \$324.9 million. This occurred because, when revaluing EOBR inventory, \$57.3 million of unrealized holding gains was not removed from the loss realized.

Medical - Dental Division. The DFAS Denver Center reported \$266.2 million of inventory at approximate historical cost and did not report any EOBR inventory. The March 31, 1997, supply stratification reports for medical - dental supplies and equipment showed that 26.2 percent, or \$73.5 million of the \$280.5 million of inventory reported at latest acquisition cost by the business divisions, should have been reported as EOBR. The EOBR inventory had a net realizable value of \$2 million, related Other Losses of \$67.8 million, and reductions to unrealized holding gains of \$3.8 million. After the reductions for the EOBR inventory, the ending inventory at approximate historical cost should have been reported as \$194.6 million.

Reparable Support Division. The DFAS Denver Center overstated ending inventory at approximate historical cost by \$2,703 million, understated Other Losses by \$950.3 million, and understated EOBR inventory at net realizable value by \$74.6 million. The ending inventory balance should have been reported at \$19.3 billion instead of \$22 billion, Other Losses should have been reported at \$4.4 billion instead of \$3.4 billion, and EOBR inventory at net realizable value should have been reported at \$169.5 million instead of \$94.9 million. This occurred because, when revaluing inventory to latest acquisition cost and revaluing EOBR inventory, the DFAS Denver Center made calculation errors that understated the latest acquisition cost by \$88.8 million, used incorrect percentages to identify EOBR inventory, and did not realize \$1.7 billion of holding gains.

Finding A. Inventory Revaluation

Systems Support Division. The DFAS Denver Center understated ending inventory at approximate historical cost by \$40.9 million, overstated Other Losses by \$3.9 million, and overstated EOBR inventory at net realizable value by \$1.1 million. The ending inventory balance should have been reported at \$1,134.7 million instead of \$1,093.9 million; Other Losses should have been reported at \$115.5 million instead of \$119.5 million; and EOBR inventory at net realizable value should have been reported at \$2.2 million instead of \$3.3 million. This occurred because, when revaluing EOBR inventory, the DFAS Denver Center used the March 31, 1995, supply stratification report instead of the March 31, 1997, report; made calculation errors; and did not realize \$36.9 million of unrealized holding losses.

Troop Support Division. The DFAS Denver Center overstated ending inventory at approximate historical cost by \$4.3 million and understated the Cost of Goods Sold by the same amount. The ending inventory balance should have been reported as \$33.0 million instead of \$37.3 million, and the Cost of Goods Sold should have been reported as \$62.2 million instead of \$58.4 million. This occurred because, when calculating the ratio of unrealized holding gains to total inventory available for sale, the DFAS Denver Center omitted \$20.5 million of inventory from the amount available for sale.

Causes of Overstatements and Understatements

Supply Stratification Reports. DFAS Denver Center personnel stated that they used the March 31, 1995, supply stratification report because the Systems Support Division did not provide a current report. They said that the use of the 1995 report was in accordance with the DoD Financial Management Regulation, which states that the latest available supply stratification report should be used. However, the March 31, 1997, supply stratification report was available, and DFAS Denver Center personnel could have requested it from the Systems Support Division. The DFAS Denver Center had current supply stratification data for the Repairable Support Division but did not use it. DFAS Denver Center personnel did not give a reason why the available current data were not used. We obtained all updated reports from the business divisions.

Calculation Errors. DFAS Denver Center personnel were not aware of the calculation errors until we identified them. DFAS Denver Center personnel determined that the calculation error in the Troop Support Division was due to the failure of a personal computer.

Unrealized Holding Gains and Losses Contained in Excess, Obsolete, and Beyond Repair Inventory. DFAS Denver Center personnel stated that they attempted to reduce losses for unrealized holding gains and to realize losses for holding losses related to inventory identified as EOBR. However, the accounting system (the Departmental On-Line Accounting and Reporting System) would not allow them to record the transactions and keep all account relationships in balance.

Finding A. Inventory Revaluation

Because the relationships between accounts were not in balance, the DFAS Denver Center could not close out the required accounts at year-end. Therefore, DFAS Denver Center personnel stated that they reversed the entries that would have reduced or realized the losses for unrealized holding gains and losses. We recognize that the required entries will cause the accounts to be out of balance and that the DFAS Denver Center will not be able to close out the required accounts at year-end. However, these entries can be made manually and incorporated in the financial statements.

Recommendations for Corrective Action

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

1. Establish procedures to:
 - a. Obtain and use the latest supply stratification reports for calculating excess, obsolete, or beyond repair inventory.
 - b. Reduce Other Losses for unrealized holding gains and increase Other Losses for unrealized holding losses related to excess, obsolete, or beyond repair inventory.
 - c. Validate the accuracy of calculations on the spreadsheet used to determine the latest acquisition costs and values of inventory that is excess, obsolete, or beyond repair.
 - d. Validate the accuracy of calculations on the worksheets used to calculate the Cost of Goods Sold.
2. Request authority and guidance from the Chief Financial Officer, DoD, or the Deputy Chief Financial Officer, DoD, to make prior period adjustments to correct the errors made in calculating and recording the account balances for ending inventory valued at approximate historical cost; for Other Losses; for Cost of Goods Sold; and for holding gains and losses.

Management Comments Required

The Director, DFAS Denver Center, did not comment on a draft of this report. We request that the Director, DFAS Denver Center, provide comments on the final report by October 30, 1998.

Finding B. Air Force General Ledger Accounts

The DFAS Denver Center had not identified and documented the accounting effects of 42 of GLAs used by the Air Force Supply Management activity group. As of September 30, 1997, the 42 GLAs contained recorded balances of \$159.5 billion. The 42 GLAs did not have written definitions, guidance for processing transactions, and posting rules. Managers at the DFAS Denver Center were aware of the condition, but had not placed a high priority on correcting it. As a result, accountants and auditors did not know what accounting effects resulted from using the 42 GLAs. In addition, audit trails did not provide the necessary basis for detecting and systematically correcting errors, as required by DoD Key Accounting Requirement No. 8, and management had no assurance that the treatment, classification, and reporting of accounting transactions were consistent with the U.S. Government and DoD Standard General Ledgers.

Policy for Financial Systems

The Joint Financial Management Improvement Program, “Core Financial System Requirements,” September 1995, establishes processing rules consistent with current policies for accounting systems, and sets the framework for all financial systems. In each department or agency, the accounting classifications, the standard general ledger and subsidiary accounts, and definitions must be standardized to ensure consistency, uniformity, and efficiency in accounting treatment, classification, and reporting. The “Core Financial System Requirements” include four processes that are vital to financial systems, including the Standard General Ledger process and the transaction control process.

Standard General Ledger Process. This process establishes the GLA structure for the agency in accordance with the U.S. Government Standard General Ledger, and establishes the rules for transaction editing and posting to record financial events. The Standard General Ledger process requires that financial systems use standardized transactions, identified by reference code; to control transaction editing; to post financial data to the appropriate GLAs; and to update other information in the system.

Transaction Control Process. Financial systems must be able to process transactions originating in other systems, recording and keeping track of such transactions and related information, in order to have central control of finances. The requirements of this process are grouped under audit trails and transaction processing.

Audit Trails. Adequate audit trails are critical to providing support for transactions and balances maintained by financial systems. Audit trails trace

Finding B. Air Force General Ledger Accounts

transactions through the financial system from source documents, original input, other systems, system-generated transactions, and internal transactions. The "DoD Financial Management Regulation," volume 1, "General Financial Management Information, Systems, and Requirements," March 16, 1993, with changes through July 1998, identifies 13 Key Accounting Requirements that accounting systems must reasonably comply with. Key Accounting Requirement No. 8 provides further guidance for audit trails.

Transaction Processing. All transactions must be handled consistently, regardless of their point of origin. Transaction processing must also comply with management controls designed to ensure that prescribed standards and procedures are followed.

DFAS Denver Center Guidance

DFAS-DE 7420.1-R, "Procedures in Support of Air Force Stock Fund," December 15, 1986, with changes through January 15, 1991, was initially issued as Air Force Regulation 170-25. DFAS-DE 7420.1-R describes the GLA and subsidiary account codes applicable to the Air Force stock fund (the Air Force Supply Management activity group). The guidance provides GLA definitions, transaction processing guidance, and posting rules that control all GLA transactions and subsidiary accounting records. DFAS-DE 7420.1-R does not convert the account codes to the U.S. Government or DoD Standard General Ledger codes.

General Ledger Accounts

In our review of the September 30, 1997, trial balance reports for the nine business divisions of the Air Force Supply Management activity group, we observed that 42 GLA codes had no documentation other than the account code and title. There were no descriptions for the 42 GLAs, and not all personnel at the DFAS Denver Center were aware of the accounting effects of these GLAs. The GLAs were not listed in DFAS-DE 7420.1-R, and account definitions, transaction processing guidance, and posting rules did not exist. Also, an additional four subsidiary accounts with recorded balances of \$34.3 million were not defined. The 42 GLAs had recorded balances of \$159.5 billion, as shown in Table 2.

Finding B. Air Force General Ledger Accounts

**Table 2. Balances of GLAs Without Definitions,
Transaction Processing Guidance, and Posting Rules
(\$ in millions)**

<u>Business Division</u>	<u>Account Balance</u>
Academy Division	\$ 144.5
Cost of Operations	3,533.1
Cost of Operations - Fuels	42.1
Fuels Division	9,302.3
General Support Division	9,077.9
Medical - Dental Division	2,363.8
Reparable Support Division	119,846.6
Systems Support Division	14,914.4
Troop Support Division	<u>311.7</u>
Total	\$159,536.4

Status of Corrective Action

Personnel at the DFAS Denver Center were aware that DFAS-DE 7420.1-R did not contain definitions, transaction processing guidance, and posting rules for all GLAs used by the Air Force Supply Management activity group. Before May 1997, the DFAS Denver Center began revising the guidance to correct this deficiency. Personnel at the DFAS Denver Center could not give an estimated completion date for the revision because other work had a higher priority.

Summary

Without written definitions, transactions processing guidance, and posting rules for all GLAs, DFAS Denver Center accountants and auditors did not know what accounting effects resulted from the use of these GLAs. In addition, audit trails did not provide the necessary basis for detection and systematic correction of errors that arise, and management had no assurance that the treatment, classification, and reporting of accounting transactions were consistent with the U.S. Government and DoD Standard General Ledgers. Until corrected, this condition will cause auditors to disclaim opinions.

Recommendations for Corrective Action

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

1. Direct the Systems and Procedures Directorate to define, document, and provide posting guidance for the 42 general ledger accounts and the four subsidiary accounts in the Air Force Supply Management activity group.

2. Ensure that the accounts provide the same accounting treatment as the corresponding DoD Standard General Ledger Accounts to which they convert.

Management Comments Required

The Director, DFAS Denver Center, did not comment on a draft of this report. We request that the Director, DFAS Denver Center, provide comments on the final report by October 30, 1998.

Part II - Additional Information

Appendix A. Audit Process

Scope

Work Performed. Our audit objective was to determine whether the DFAS Denver Center consistently and accurately compiled financial data from field activities and other sources for the FY 1997 Air Force Working Capital Fund Financial Statements. We limited our review of the compilation process to a review of inventory revaluation methods and the accounting treatment of general ledger accounts in the Air Force Supply Management Activity Group. The Air Force Working Capital Fund consists of five activity groups. In FY 1997, the Supply Management activity group had inventory of \$24.5 billion. Total assets in the Air Force Working Capital Fund were \$28.7 billion. The Supply Management activity group consisted of nine business divisions, of which seven had inventory. We reviewed the inventory revaluation process for all seven business divisions with inventory.

We reviewed the procedures used by the DFAS Denver Center to revalue inventory from standard price to latest acquisition cost to approximate historical cost. In addition, we determined the accuracy of the computations made using those procedures. Air Force field activities reported that at standard price, these inventories were valued at \$55.5 billion. The DFAS Denver Center revalued these inventories to an approximate historical cost of \$24.5 billion for reporting on the FY 1997 Air Force Working Capital Fund Financial Statements. The approximate historical cost included the net realizable value of inventory identified as excess, obsolete, and beyond repair (EOBR). We reviewed the accuracy of the procedures used by the DFAS Denver Center to identify and revalue inventory as EOBR.

We determined whether the accounting treatment of the general ledger accounts used by all nine business divisions of the Supply Management activity group was consistent with the DoD Standard General Ledger chart of accounts. To make this determination, we reviewed general ledger account balances from trial balances for the nine business divisions, as of September 30, 1997.

DoD-wide Corporate-Level Government Performance and Results Act Goals. In response to Public Law 103-62, the "Government Performance and Results Act of 1993," August 3, 1993, the Department of Defense has established 6 DoD-wide corporate-level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal.

- **Objective:** Fundamentally reengineer the DoD and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Financial Management Area: Objective:** Reengineer DoD business practices. **Goal:** Standardize and enhance Defense Working Capital Fund operating procedures. **(FM-4.4)**

GAO High-Risk Areas. The General Accounting Office has identified several high-risk areas in the Department of Defense. This report provides coverage of the Defense Financial Management and Defense Inventory Management high-risk areas.

Methodology

Use of Computer-Processed Data. The Departmental On-Line Accounting and Reporting System is used to prepare trial balance reports for the Air Force Supply Management activity group from summarized data reported by other systems of the Air Force and from data adjustments made by the DFAS Denver Center. The trial balance reports were in error because of the conditions discussed in Finding A, and the balances for 42 general ledger accounts were not verifiable because of the conditions discussed in Finding B.

Audit Type, Dates, and Standards. We performed this financial-related audit from October 1997 through May 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We included tests of management controls considered necessary.

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

Management Control Program

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 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 Management Control Program. We reviewed the adequacy of the DFAS Denver Center's management controls for the revaluation of inventory for financial statement reporting and support for logistics accounting systems. Specifically, we reviewed policies, procedures, and computations for the revaluation of inventory from standard price to latest acquisition cost to

Appendix A. Audit Process

approximate historical cost; the identification and valuation of EOBR inventory; and the definitions, transaction processing guidance, and posting rules for general ledger accounts in the Air Force Supply Management activity group. We reviewed management's self-evaluation of those controls.

Adequacy of Management Controls. We identified material management control weaknesses as defined in DoD Directive 5010.38. Management controls at the DFAS Denver Center were not adequate to ensure that inventory reported at approximate historical cost, EOBR inventory, Other Losses, and Cost of Goods Sold were accurately computed and reported on financial statements; and that written definitions, transaction processing guidance, and posting rules were provided for all general ledger accounts in the Air Force Supply Management activity group. Recommendations A.1., A.2., B.1., and B.2., if implemented, will result in more accurate financial statement reporting and improved support for logistics accounting systems. A copy of the audit report will be provided to the senior officials in charge of management controls at the DFAS Denver Center.

Adequacy of Management's Self-Evaluation. DFAS Denver Center officials identified the revaluation of inventory for financial statement reporting and support for logistics accounting systems as parts of two assessable units. However, DFAS Denver Center officials did not identify the specific material management control weaknesses identified by the auditors because the DFAS Denver Center evaluations covered broader areas.

Appendix B. Summary of Prior Coverage

Since 1991, when the Defense Business Operations Fund (now the DoD Working Capital Fund) was established, the General Accounting Office and the Inspector General, DoD, have published audit reports on financial management and inventory. The Inspector General, DoD, has also issued a report on issues related to the financial statements of the Air Force Working Capital Fund.

General Accounting Office

General Accounting Office Report No. HR-97-3, "Defense Financial Management," February 1997

General Accounting Office Report No. HR-97-5, "Defense Inventory Management," February 1997

Inspector General, DoD

Report No. 98-108, "Inspector General, DoD, Oversight of the Air Force Audit Agency Audit of the FY 1997 Air Force Working Capital Fund Financial Statements," April 7, 1998

Report No. 98-072, "Defense Business Operations Fund Inventory Record Accuracy," February 12, 1998

Report No. 98-050, "Audit Report on Defense Business Operations Fund Adjustments at the Defense Finance and Accounting Service Denver Center," January 20, 1998

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Director, Accounting Policy
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

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

Other Defense Organizations

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

Non-Defense Federal Organizations and Individuals

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

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