

Audit



Report

COMPILATION OF THE FY 1997 ARMY WORKING CAPITAL FUND
FINANCIAL STATEMENTS

Report Number 98-216

September 29, 1998

Office of the Inspector General
Department of Defense

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Acronyms

AAA	Army Audit Agency
AR	Accounting Report
CFO	Chief Financial Officers
DFAS	Defense Finance and Accounting Service
FFS	Federal Financial System
GAO	General Accounting Office
IG	Inspector General
OMB	Office of Management and Budget
USD(C)	Under Secretary of Defense (Comptroller)
WCF	Working Capital Fund



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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September 29, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on the Compilation of the FY 1997 Army Working Capital
Fund Financial Statements (Report No. 98-216)

We are providing this audit report for review and comments. We performed this audit as part of our audit of the FY 1997 DoD-Wide Consolidated Financial Statements, in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994.

The Director of Defense Finance and Accounting Service did not comment on a draft of this report. DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. Therefore we request that the Director, Defense Finance and Accounting Service, provide comments on the final report by October 29, 1998.

We appreciate the courtesies extended to the audit staff. If you have any questions about the audit, please contact Mr. Richard B. Bird at (703) 604-9175 (DSN 664-9175), e-mail rbird@dodig.osd.mil, or Mr. Jack L. Armstrong at (317) 510-3846 (DSN 699-3846), e-mail jarmstrong@dodig.osd.mil. See Appendix C for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in black ink that reads "David K. Steensma".

David K. Steensma
Deputy Assistant Inspector General
For Auditing

Office of the Inspector General, DoD

Report No. 98-216
(Project No. 7FI-2034 02)

September 29, 1998

Compilation of the FY 1997 Army Working Capital Fund Financial Statements

Executive Summary

Introduction. This is the second in a series of audit reports relating to the audit of the FY 1997 Army Working Capital Fund Financial Statements. The first report was on our oversight of the Army Audit Agency audit of the FY 1997 Army Working Capital Fund Financial Statements. We performed the audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires that DoD provide audited financial statements to the Office of Management and Budget.

The Chief Financial Officers Act requires the Inspector General, DoD, to audit the financial statements of DoD organizations in accordance with generally accepted Government auditing standards. The Inspector General, DoD, delegated the audit of the FY 1997 Army Working Capital Fund Financial Statements to the Army Audit Agency. We assisted the Army Audit Agency by performing audit work at the Defense Finance and Accounting Service (DFAS) Indianapolis Center. The Army Audit Agency disclaimed an opinion on the FY 1997 Army Working Capital Fund Financial Statements and we endorsed the disclaimer. The FY 1997 Army Working Capital Fund Financial Statements reported total assets of \$14.5 billion, liabilities of \$1.9 billion, revenues and financing sources of \$9.7 billion, and expenses of \$11.5 billion.

Audit Objective. The overall audit objective was to determine whether the DFAS Indianapolis Center consistently and accurately compiled financial data from field activities and other sources for the financial statements of the Army Working Capital Fund. Specifically, we evaluated whether the compilation of financial information for the FY 1997 financial statements was complete and materially correct, and whether the Notes to the financial statements fully disclosed material discrepancies and additional information relevant to the statements. In addition, we reviewed internal controls and compliance with laws and regulations as they related to the audit objective.

Audit Results. The compilation process used by the DFAS Indianapolis Center needed improvements to ensure that the financial statements prepared for the Army Working Capital Fund were complete, accurate, and fully supported. Specifically, the DFAS Indianapolis Center:

- made year-end adjustments of \$9.4 billion (absolute value) to the FY 1997 account balances certified by the field activities, of which \$2.1 billion (absolute value) were not fully supported (Finding A); and
- did not prepare accurate and complete footnotes to the financial statements (Finding B).

As a result, the FY 1997 Army Working Capital Fund Financial Statements compiled by the DFAS Indianapolis Center were not reliable and did not accurately or completely present the financial condition and results of operations.

Summary of Recommendations. We recommend that the DFAS Indianapolis Center explain and document adjustments made during the compilation process, review all manual adjustments for accuracy and completeness, and obtain supporting documentation from the activity that requests the adjustment. Also, the DFAS Indianapolis Center should establish procedures to verify that all relevant financial information is disclosed; document and explain all amounts in the footnotes; and disclose balances that required correction because of deficiencies in the accounting systems.

Management Comments. The Director, DFAS, did not respond to a draft of this report. We request that the Director provide comments on the final report by October 29, 1998.

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Part I - Audit Results

Audit Background

This is the second in a series of audit reports on the FY 1997 Army Working Capital Fund (WCF) financial statements. The first report was our oversight of the Army Audit Agency (AAA) audit of the FY 1997 Army WCF financial statements. This report summarizes the compilation process at the Defense Finance and Accounting Service (DFAS) Indianapolis Center and reflects the audit work jointly performed by the Inspector General (IG), DoD, and the AAA.

Chief Financial Officers Act. The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD and other Government agencies to prepare financial statements covering substantial commercial functions, revolving funds, and trust funds. These agency-wide financial statements are audited and submitted to the Director, Office of Management and Budget (OMB), beginning in FY 1996 and each succeeding year. The CFO Act also requires the IGs, or appointed external auditors, to audit financial statements in accordance with generally accepted Government auditing standards and other standards established by the OMB.

Roles and Responsibilities. The Under Secretary of Defense (Comptroller) (USD[C]) as the Chief Financial Officer, DoD, is responsible for overseeing the preparation of agency-wide financial statements. The USD(C) is also responsible for providing accounting policy and procedures to DoD. The Defense Finance and Accounting Service Centers perform accounting functions and prepare financial statements for DoD entities.

Role of the DFAS Indianapolis Center. DoD field accounting activities submit general ledger trial balances and financial data on the status of appropriations to the DFAS Indianapolis Center. Two directorates at the DFAS Indianapolis Center prepare the Army WCF financial statements, the Defense Accounting Directorate and the Departmental Accounting Directorate. The Defense Accounting Directorate prepares the monthly and year-end Defense Working Capital Fund Accounting Reports (AR) 1307 for the consolidated business areas as well as the Army entity levels, and maintains departmental accounting records. The Departmental Accounting Directorate prepares the Army WCF financial statements.

General Ledger Data From Field Activities. Each month, field accounting entities supported by the DFAS Indianapolis Center submit a general ledger trial balance directly to the Federal Financial System (FFS), a general ledger module of the Headquarters Accounting and Reporting System. Most accounting entities' general ledgers are transaction-driven; however, some financial data submitted to the DFAS Indianapolis Center are not generated by an integrated transaction-driven general ledger system.

Preparation of Accounting Reports. The Defense Accounting Directorate prepares the monthly AR 1307, for each field accounting entity. The general ledger data are supplemented with information from other sources, such as Accounting Report 1302 (Statement 7), Cost Accounting Budget general ledger, Reports on Budget Execution, and the Army WCF Cash Management Report.

The Defense Accounting Directorate adjusts the data to agree with certified data on the status of appropriations, to record field accounting adjustments, to revalue inventory, to record undistributed collections and disbursements, to reconcile with the Department of the Treasury's records, and to record assets. After the general ledger is balanced, the general ledger data are used to prepare the monthly AR 1307s. Each field accounting entity reviews its AR 1307 for accuracy and completeness, and certifies it. At the end of the fiscal year, the Defense Accounting Directorate produces the year-end AR 1307. AAA, after reviewing the adjustment to the FY 1997 general ledger data, determined that \$29.8 billion (absolute value) in adjustments was not supported.

Data on the Status of Appropriations. During the fiscal year, the DFAS Indianapolis Center records the data on the status of the Working Capital fund appropriation. The data are adjusted to match year-end status-of-appropriations reports certified by responsible officials. All installations are required to fax, mail, or electronically submit copies of their monthly status reports. The balances in the FFS are then reconciled to the hard copy reports. If necessary, adjustments are made so that status-of-appropriations data agree with the beginning balances certified from the prior year and ending balances submitted for the current reporting period. The certified status-of-appropriations data are then reconciled to the net expenditures recorded by the Department of the Treasury. Status data are used to compile the Status of Reimbursements (112) report, the Status of Approved Resources (218) report, and the Report on Budget Execution (SF 133). The status-of-appropriations data are also reconciled with the AR 1307. If the two reports differ, the AR 1307 is adjusted to agree with the status-of-appropriations data.

Preparation of the Financial Statements. The Departmental Accounting Directorate prepares the Army WCF financial statements from data downloaded to a microcomputer database known as the Source File. The Departmental Accounting Directorate makes additional adjustments directly to the Source File. Adjustments are made for many reasons, including changing general ledger accounts to match certified status-of-appropriations data, recording auditor's adjustments, making intra-agency eliminations, and meeting special reporting requirements. After the adjustments have been made, the Departmental Accounting Directorate converts the Source File into the Army WCF financial statements. We reviewed the adjustments made by the Departmental Accounting Directorate to the Source File. The DFAS Indianapolis Center adds footnotes and supplementary schedules, and the Assistant Secretary of the Army (Financial Management and Comptroller) adds an overview section to the financial statements to create the Army WCF financial statements.

Army Working Capital Fund Financial Statements. The Army WCF FY 1997 Financial Statements consist of the Statement of Financial Position; the Statement of Operations and Changes in Net Position, the Statement of Cash Flow, along with the supporting footnotes; and the management overview on the Army WCF statements. The Army WCF included total assets of \$14.5 billion, liabilities of \$1.9 billion, expenses of \$11.5 billion, and revenues of \$9.7 billion.

Audit Objectives

The overall audit objective was to determine whether the DFAS Indianapolis Center consistently and accurately compiled financial data received from field activities and other sources for the financial statements of the Army WCF. Specifically, we evaluated whether the compilation of financial information for the FY 1997 financial statements was complete and materially correct, and whether the Notes to the financial statements fully disclosed material discrepancies and additional information. We also reviewed internal controls and compliance with laws and regulations as they related to the audit objective. See Appendix A for a discussion of the audit scope, methodology, management control program, and prior audit coverage.

Finding A. Process for Accounting Adjustments

The DFAS Indianapolis Center made material accounting adjustments that were not adequately supported or were incorrect.

- Fifteen unsupported adjustments for \$2.1 billion (absolute value) were made to make the Source File agree with the AR 1307, and
- Based on adjustments recommended by AAA, the account for Excess, Obsolete, and Unserviceable Operating Materials and Supplies was overadjusted, causing an understatement of \$6.5 million.

These conditions existed because the DFAS Indianapolis Center did not follow DoD procedures and policy. DFAS Indianapolis Center did not review and reconcile reported accounting data to source records for lack of valid audit trails. As a result, the FY 1997 Army WCF financial statements were materially unreliable, and if the systemic problems are not corrected, the FY 1998 statements will contain errors.

Guidance for Compilation

Federal Financial Management Improvement Act of 1996. The Federal Financial Management Improvement Act of 1996 requires each Federal agency to implement and maintain financial management systems that comply with Federal financial management requirements for systems, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level.

OMB Guidance. OMB Circular No. A-127 Revised, “Financial Management Systems,” July 23, 1993, states, “The design of the financial management systems shall reflect an agency-wide financial information classification structure that is consistent with the U.S. Standard General Ledger.”

“The DoD Financial Management Regulation DoD 7000.14-R. DoD Regulation 7000.14-R, the “DoD Financial Management Regulation,” volume 1, chapter 3, “Accounting Systems Conformance, Evaluation, and Reporting,” states, “The system must have general ledger control and maintain an appropriate account structure approved by DoD. The general ledger account structure must follow the general ledger accounts for assets, liabilities, equity, expenses, losses, gains, transfers in and out, and financing sources.”

The “DoD Financial Management Regulation” includes the DFAS responsibilities for the preparation of the financial statements volume 6, “Reporting Policy and Procedures,” February 12, 1996. The regulation requires DFAS to establish procedures to ensure that the preparation of financial statements is timely and auditable, and that controls are in place to provide accurate and complete statements. It states “. . . the DFAS shall support

Finding A. Process for Accounting Adjustments

adequately and justify in writing any adjustment to the official accounting records.” The regulation also states that the documentation of adjustments should be detailed enough to provide an audit trail. The regulation requires that the DoD Components review all financial statements prepared by DFAS to ensure that the amounts are consistent and reconcilable with the data in their management reports.

Accounting Adjustments to Source File

The Departmental Accounting Directorate prepared 140 Source File adjustments valued at about \$9.4 billion (absolute value) while compiling the FY 1997 Army WCF financial statements. These adjustments were made to the Source File to match AR 1307 certified data, record auditor’s adjustments, and make intra-agency eliminations. Fifteen accounting adjustments with an absolute value of \$2.1 billion (22 percent) were not supported. Also, the adjustment recommended by AAA for valuing Excess, Obsolete, and Unserviceable Operating Materials and Supplies was understated on the financial statements by \$6.5 million.

Adjustments to Match FFS and AR 1307 Certified Data. The preparation of the manual general ledger adjustments was a complex task, that was not efficient or well controlled. When preparing the financial statements, the DFAS Indianapolis Center does not use a transaction-driven, integrated accounting system based on general ledger accounting. Two directorates make accounting adjustments that affect the Army WCF financial statements. The Departmental Accounting Directorate considers the AR 1307 to be more reliable because it has been certified by the officials in the field. The adjustments made by the Departmental Accounting Directorate showed \$2.1 billion (absolute value) of unsupported adjustments to the Source File.

Based on the results of a recent AAA report, DFAS has no guarantee that the FFS general ledger data or AR 1307 data are any more correct than the Source File used to prepare the Army WCF financial statements. The AAA reviewed the adjustments made by the Defense Accounting Directorate and identified an additional \$29.8 billion (absolute value) in adjustments to the FFS general ledger data that were inadequately documented and could not be verified.

Adjusting Accounting Transactions. Six journal adjustments for \$1.4 billion (absolute value) were made to correct accounting transactions extracted from the FFS general ledger data used to prepare the Army WCF financial statements. Personnel in the Departmental Accounting Directorate believed that the general ledger data balances were extracted twice from the FFS. The six journal vouchers were prepared to eliminate this duplicate information. However, the DFAS Indianapolis Center did not have any record of information that might have been transmitted incorrectly. No audit trail existed to trace the adjustments back to the original data or specific transactions. Therefore, we could not validate the reasons for the adjustments. Personnel in Departmental Accounting Directorate did not reconcile the sources of financial data to determine which figures did not transfer whether the FFS or the AR 1307 contained errors. Table 1 shows the amounts of adjustments to accounts in the Army WCF financial statements.

Finding A. Process for Accounting Adjustments

Table 1. Summary of Six Journal Voucher Adjustments

Account	Total (Net)	Total (Absolute)
Fund Balance With Treasury	\$ (22,678,488.19)	\$ 224,292,196.91
Accounts Receivable, Net	(34,928,948.11)	54,842,127.27
Advances and Prepayments	(915,525.92)	2,280,908.40
Property and Equipment, Net	(181,776.45)	1,336,648.03
Accounts Payable	35,255,057.54	37,929,663.80
Accrued Payroll and Benefits	18,547,688.15	26,931,833.59
Net Position, Beginning Balance, as Previously Stated	12,849,074.64	56,055,441.48
Revenues From Sales of Goods and Service	133,061,099.02	133,061,099.02
Program or Operating Expenses	(282,887,654.17)	347,703,385.35
Depreciation and Amortization	(4,570,515.92)	4,570,515.92
Cost of Goods Sold	146,449,989.41	528,378,301.09
Total		\$1,417,382,120.86

Adjustments to Make Source Data Agree With AR 1307. Personnel at the DFAS Indianapolis Center prepared 9 journal vouchers for \$692 million (absolute value) to make the source data agree with the AR 1307. They prepared the vouchers because they assumed that when financial data in the FFS were transferred to the Source File, not all of the data made the transfer. They made this assumption because the data they received did not equal the amounts in AR 1307. Rather than re-transmit the FFS data and possibly duplicate the data already received, DFAS Indianapolis Center personnel prepared journal vouchers to make the Source File agree with the AR 1307. However, no audit trail existed to trace the adjustments back to the original data, or to specific transactions, so we could not validate the reasons for the adjustments. DFAS Indianapolis Center personnel did not reconcile the sources of financial data to determine which amounts were not transferred or whether the FFS or AR 1307 contained errors. DoD guidance requires sufficient documentation for making an adjustment to the financial statement data. Table 2 shows the amounts of adjustments to accounts on the Army WCF financial statement.

Finding A. Process for Accounting Adjustments

<u>Account</u>	<u>Total (Net)</u>	<u>Total (Absolute)</u>
Fund Balance With Treasury	\$ (33,129,711.94)	\$ 239,996,978.30
Accounts Receivable, Net	33,841,481.31	37,355,780.45
Inventory, Net	(1,442,630.10)	1,442,630.10
Increase (Decrease) in Accounts Payables	857,229.00	857,229.00
Increase (Decrease) in Other Liabilities	25,894.12	25,894.12
Plus (Minus) Non Operating Changes	396,093.17	36,021,979.13
Revenues From Sales of Goods and Services	(93,273,770.15)	96,787,246.51
Program or Operating Expenses	85,626,244.39	86,741,477.61
Depreciation and Amortization	4,863,544.00	4,863,544.00
Cost of Goods Sold	2,255,659.97	187,811,473.25
Other Expenses	<u>(20,033.77)</u>	<u>20,033.77</u>
Total		\$691,924,266.24

Auditor-Recommended Adjustments. The DFAS Indianapolis Center did not properly calculate or record adjustments recommended by the AAA. The AAA reviewed a draft of the FY 1997 Army WCF Financial Statements and related footnotes for accuracy and compliance with DoD Financial Management Regulation 7000.14R, volume 6, Form and Content guidance. AAA recommended that the DFAS Indianapolis Center decrease the value of Excess, Obsolete, and Unserviceable Operating Materials and Supplies to the net realizable value. Statement of Federal Accounting Standard No. 3, and DoD Financial Management Regulation 7000.14R, volume 6, Form and Content require the excess materials to be valued at net realizable value. The AAA auditors stated that “the amounts recorded in the account are standard prices reported from field activities. A memorandum from the Accounting Service states excess inventory should be valued at 2.7 percent of standard price. Once the item is transferred to property disposal, the remaining 2.7 percent of the loss should be recognized.” AAA calculated the adjustment to be \$33.1 million

The DFAS Indianapolis Center concurred with this recommendation. However, when DFAS made the adjustment, it did not properly calculate the journal vouchers to record net realizable value. As a result, the net realizable value of Excess, Obsolete, and Unserviceable Operating Materials and Supplies was calculated and recorded at \$39.6 million. This over-adjustment caused the account to be understated by \$6.5 million. DFAS Indianapolis Center personnel stated that the spreadsheet formulas may have been mixed-up. This error could have been found and corrected if the DFAS Indianapolis Center had reviewed the proposed adjustments.

Summary

The DFAS Indianapolis Center's process for compiling the Army WCF financial statements needed improvement to ensure that the financial statements were complete and accurate. These conditions existed because the DFAS Indianapolis Center did not follow the procedures in the "DoD Financial Management Regulation." Also, the DFAS Indianapolis Center did not review and verify that manual adjustments made to the financial statements were correct. As a result, the FY 1997 Army WCF financial statements were unreliable, and if the systemic problems are not corrected, the FY 1998 statements will contain errors.

Recommendations for Corrective Action

We recommend that the Director, Defense Finance and Accounting Service, direct the Defense Finance and Accounting Service Indianapolis Center to comply with management control procedures for compiling the Army Working Capital Fund financial statements. Specifically,

A.1. Reconcile the Source File to the Accounting Report 1307 and general ledger data.

a. Determine what specific transactions were incorrectly transmitted or omitted from the Source File.

b. Document adjustments made during the compilation process in accordance with the "DoD Financial Management Regulation."

A.2. Review all manual adjustments for accuracy and completeness, and request documentation from the activity requesting the adjustment.

Management Comments Required

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

Finding B. Footnote Disclosure

Footnote disclosure in the FY 1997 Army WCF financial statements needed improvement. The footnotes to the financial statements were not supported and contained mathematical errors. Footnotes did not fully explain the causes of large variances in financial statement line items from year to year, and necessary disclosures concerning Non-Operating Changes were incomplete. This condition occurred because the DFAS Indianapolis Center did not implement existing policy for footnote disclosure. Also, the DFAS Indianapolis Center had not developed formal procedures to verify that all relevant financial data were fully disclosed in the footnotes to the financial statements. As a result, the FY 1997 Army WCF financial statements were less useful.

Criteria and Responsibilities

Criteria. The American Institute of Certified Public Accountants Statement on Auditing Standards No. 32, "Adequacy of Disclosure in Financial Statements," October 1980, states, "The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters." OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, states that "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." The Federal Accounting Standards Advisory Board Concept Statement No. 2, "Entity and Display," April 20, 1995, states in paragraph 68 that "Financial information is also conveyed with accompanying footnotes, which are an integral part of the financial statements. Footnotes typically provide additional disclosures that are necessary to make the financial statements more informative and not misleading." The Financial Management Regulation, volume 6, chapter 6, "Form and Content of Audited Financial Statements," January 1998, establishes specific requirements for footnotes to principal financial statements. As a result of a prior audit recommendation, the DFAS Indianapolis Center established policy that material year-to-year variances not resulting from normal operations should be explained in the financial statement footnotes.

Responsibilities. The Directorate for Departmental Accounting at the DFAS Indianapolis Center is responsible for developing the footnotes to the Army WCF financial statements.

Footnote Disclosure

Footnote disclosure in the FY 1997 Army WCF financial statements needed improvement. As required by the Statement on Auditing Standards No. 32, "Adequacy of Disclosure in Financial Statements," we examined the footnotes prepared by the DFAS Indianapolis Center for the FY 1997 Army WCF financial

Finding B. Footnote Disclosure

statements. We determined that three footnotes to the financial statements were not supported. The footnotes should have better explained the causes for large variances in financial statement line items from year to year. Also, other necessary disclosures concerning Non-Operating Changes were incomplete. This occurred because the DFAS Indianapolis Center did not implement existing policy regarding footnote disclosure. Also, while the DFAS Indianapolis Center had several Standing Operating Procedures that discussed various aspects of financial statement presentation, none of the procedures addressed the preparation of the footnotes for the CFO financial statements. Footnote procedures should include a checklist of items that should be reviewed for the preparation of footnotes.

Support for Footnote Disclosures. Accurate and complete footnotes to the financial statements were not prepared. Footnotes are to be detailed and give an explanation that will assist the reader to more fully understand the financial statements. Three of the footnotes on the Army WCF financial statements lacked detail and tended to add more confusion than clarification. Because of system limitation, many of the footnotes to the Army WCF financial statements are manually prepared. DFAS Indianapolis personnel must take precautions to ensure that the figures generated, and figures entered manually into the financial statements are correct. Some of the figures on the draft Army WCF financial statements were erroneous and others were pulled from sources outside of the microcomputer system. The following discusses the errors with the three footnotes.

- **Other Revenue and Financing Sources, Footnote 22.** There was no documentation or explanation for the \$4.4 million shown as miscellaneous Gains. DFAS Indianapolis personnel could not tell us what it represented. This figure was used to bring the line into balance with its corresponding line on the Statement of Operations and Changes in Net Position. Guidance in the DoD Financial Management Regulation requires that the identity and amount of Other Revenue and Financing Sources be reported. It also requires that other information relative to Other Revenues and Financing Sources be disclosed.
- **Prior Period Adjustments, Footnote 27.** This footnote includes lines titled "Funding for Prior Period Unfunded BRAC Costs," and "Other," which contain unsupported balances of \$62.9 million and \$11.5 million respectively. DFAS Indianapolis personnel told us that the \$62.9 million figure was given to them from the Rock Island Operating Location in Rock Island, Ill. However, they did not have adequate documentation as to what it represented. We contacted personnel at the Rock Island Operating Location and they had no documentation for this balance. In fact, this was not the figure the Rock Island Operating Location had given to the DFAS Indianapolis Center. Personnel at the DFAS Indianapolis Center could not document the \$11.5 million figure. The DoD Financial Management Regulation requires that the nature and amount of prior period adjustments be disclosed. Because the \$11.5 million brought the Prior Period Adjustments into balance with the corresponding Adjustments line on the Statement of Operations and Changes in Net Position, an explanation as to what it represents is required.

Finding B. Footnote Disclosure

- **Non-Operating Changes (Transfers and Donations), Footnote 28.** The amounts reported for Non-Operating Changes (Transfers and Donations) on the Comprehensive Reporting System were negative. However, the amount reported on the footnotes to the FY 1997 Army WCF financial statements was positive. No documentation explained why the amounts were reversed. The DoD Financial Management Regulation states that any transaction that increases the net position should be shown in the footnotes as an increase; likewise, any transaction that decreases the net position should be shown as a decrease. The Comprehensive Reporting System showed a transaction of a negative \$53.8 million as a transfer out of cash. However, on the footnote, the amount is shown as an increase to cash. Personnel at the DFAS Center stated that this would be a transfer in of cash. They stated that a problem in the system caused the amounts to be reported as negative, and that they corrected the amounts by transferring it to the positive side. However, no documentation showed that this had been identified as a systems problem, or that this amount was an actual negative transfer out of cash. Personnel at the DFAS Indianapolis Center should coordinate with their field activities to determine what the actual amounts represent, make corrections, and retain supporting documentation.

Footnote Disclosure of Year-To-Year Variances in Balances on Financial Statement Line Items. Footnote disclosures would have better explained the causes for large variances in financial statement line items from year to year. In the FY 1997 Army WCF financial statements, 16 lines that had large variances from the prior year (see Appendix B, “Year-To-Year Variances,” for a list of the 16 lines). Twelve of the 16 lines should have been better explained in the footnotes. Three examples follow.

- **Other Non-Federal Liabilities.** Line 5.b(5) of the FY 1997 Army WCF Statement of Financial Position that for FY 1997 unfunded non-federal liabilities had a balance of \$387.1 million, a 127 times the \$3 million balance in FY 1996. Over \$381 million of this difference was due to the first-time recognition of certain types of environmental liabilities. In Footnote 17 - Other Liabilities, DFAS Indianapolis Center did not disclose that the environmental liabilities were recognized for the first time or how this circumstance affected the financial statements.
- **Cumulative Results of Operations.** Line 7.c. of the FY 1997 Army WCF Statement of Financial Position showed that for FY 1997 Cumulative Results of Operations had a negative balance of \$3.45 billion, a 445 percent increase from the \$633.5 million negative balance in FY 1996. The DFAS Indianapolis Center did not explain this difference.
- **Future Funding Requirements.** Line 7.e. of the FY 1997 Army WCF Statement of Financial Position showed that for FY 1997 Future Funding requirements had a negative balance of \$516 million, a 894 percent increase from the \$51.9 million negative balance in FY 1996. The DFAS Indianapolis Center did not explain this difference.

If material year-to-year changes are not fully explained in the footnotes, the reasons for the large variances in line item balances may not be properly understood. Incomplete explanations reduce the usefulness of the financial statements.

Other Necessary Disclosures. The DFAS Indianapolis Center did not disclose all information necessary for a complete understanding of non-operating changes on the FY 1997 Army WCF Financial Statements. Personnel at the DFAS Indianapolis Center did not explain the meaning of the Transfers In and Transfers Out in Footnote 28, Non-Operating Changes. The U.S. Government Standard General Ledger defines Transfers In as the value of assets received from others without reimbursement, and Transfers Out as the value of assets transferred to others without reimbursement. Note 28 reports Transfers In of \$3.2 billion and Transfers Out of \$1.2 billion. However, these amounts do not represent actual transfers of assets to and from the Army. Rather, they are the results of departmental general ledger adjustments made while preparing the financial statements. This should be explained in Footnote 28.

Summary

The DFAS Indianapolis Center provided insufficient disclosure footnotes for the FY 1997 Army WCF financial statements. Disclosures are an integral part of the financial statements. These enhancements to the footnotes would significantly improve the usefulness of the financial statements.

Recommendations for Corrective Action

We recommend that the Director, Defense Finance and Accounting Service, direct the Defense Finance and Accounting Service Indianapolis Center to:

- B.1. Establish procedures to verify that all material financial information is disclosed.
- B.2. Document and explain all figures in the footnotes and disclose balances that needed correction because of deficiencies in the accounting system.
- B.3. Coordinate with the field activities of the Army Working Capital Fund to determine what the actual Transfer In and Transfer Out amounts represent, and make corrections, and retain the supporting documentation.

Management Comments Required

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

Part II - Additional Information

Appendix A. Audit Process

Scope

Our audit work was limited to an examination of the DFAS Indianapolis Center's processes, procedures, and management controls for compiling financial data from field activities and other sources into the FY 1997 Army WCF financial statements. We reviewed the supporting documentation for the 140 journal voucher adjustments totaling \$9.4 billion (absolute value) that Departmental Accounting Directorate made to the source data file. We also reviewed the support and presentation of the footnotes for the FY 1997 Army WCF financial statements. These 140 adjustments and footnotes were material to the FY 1997 Army WCF financial statements. The following table summarizes the reasons for and amounts of the adjustments.

Summary of Adjustments (in millions)				
<u>Reason for Adjustment or Journal Voucher</u>	<u>JV No.</u>	<u>JV</u> (percent)	<u>Amount</u> (absolute)	<u>Percent</u>
Prior month 1307 balances were incorrectly entered into SCOURCE 97	6	4.29	\$1,416	15.00
To bring SOURCE 97 into agreement with the AR 1307	9	6.43	692	7.32
To record pension expenses	3	2.14	332	3.52
To delete entries for advances and prepayments	1	0.71	72	0.76
To prorate costs and adjust revenue between Government and Non-Government	83	59.29	5,594	59.26
To record actuarial liabilities for future worker's compensation benefits for Federal employees	1	0.71	418	4.43
To adjust value of excess, obsolete, and unserviceable operating materials and supplies to net realizable value	13	9.29	80	0.85
To reclassify material returned for credit to wholesale supply system	12	8.57	60	0.64
To record future funding requirements for environmental liabilities	10	7.14	762	8.07
To correct adjustments made for Note 8	2	1.43	20	0.21
Totals	140	100.00	\$9,446	100.00

Audit of the FY 1997 Army WCF Financial Statements. The Inspector General, DoD, delegated the FY 1997 audit of the Army WCF Financial Statements to the AAA. The AAA performed work at the Army field entities that perform accounting functions, major commands, and DFAS Operating Locations. AAA also examined the accounting adjustments between the Army field entities' records and the AR 1307 completed by the Defense Accounting Directorate.

Limitations to Audit Scope. We did not examine the accuracy of data submitted by Army field entities or other sources, or attempt to reconcile the data with subsidiary records. We compared the Fund Balance With Treasury, recorded by the Department of the Treasury for the Army WCF to the Fund Balance With Treasury reported in the Army WCF financial statements. We did not examine the management overview of the financial statements.

DoD-Wide Corporate-Level Government Performance and Results Act (GPRA) Goals. In response to the GPRA, 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 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 Functional Area. Objective:** Consolidate finance and accounting operations. **Goal:** Consolidate and standardize financial systems. **(FM-2.1)**
- **Financial Management Functional Area. Objective:** Strengthen internal controls. **Goals:** Improve compliance with the FMFIA. **(FM-5.3)**

General Accounting Office High Risk Area. The General Accounting Office (GAO) has identified several high-risk areas in DoD. This report provides coverage of the Defense Financial Management high-risk areas.

Methodology

Audit Work Performed. Our review of the compilation of the FY 1997 Army WCF financial statements covered the processes, procedures, and management controls at the DFAS Indianapolis Center for consolidating financial data from field activities and other sources. This data was used to prepare the version of the Army WCF financial statements submitted to the auditors on January 6, 1998. We reviewed the following processes:

- establishing beginning account balances;
- establishing the Fund Balance With Treasury line item balance for the Army WCF, including:
 - controls over the reconciliation of outstanding discrepancies between Army reports of deposits and payments and Treasury records;

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- reconciliation of outstanding discrepancies between Army records of checks issued and Treasury records; and
 - reconciliation of Army status of appropriations records to the Treasury trial balance.
 - making adjustments to status of appropriations data; and
 - producing the Army WCF Financial Statement for FY 1997, excluding the Army overview.

Our audit focused on the rationale that the DFAS Indianapolis Center used to make these adjustments and the adequacy of footnote disclosures on the financial statements. We inspected the journal voucher control log, the journal voucher cover sheets, and the journal vouchers to determine whether the proper separation of duties existed. We ascertained that the preparer, approving official, and certifier were separate individuals. The journal voucher control log is maintained by the Internal Control and Development Support Team. We compared the computer program used to extract the financial information for the FY 1997 financial statements to hard copies of the FY 1997 financial statements. We also compared the information in the Notes to the financial statements with the requirements in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. In addition, we interviewed personnel at the DFAS Indianapolis Center about the compilation of the financial statements.

Use of Computer-Processed Data. We did not rely on the computer-processed data used to prepare the FY 1997 Army WCF financial statements because DoD accounting and related systems were unreliable, and the financial statements were unauditable. DoD has candidly addressed deficiencies in the financial management systems in its Annual Statement of Assurance and the management representation letter for FY 1997. The unreliable computer-processed data used in preparing the financial statements and this report, were the only financial data available. We reviewed the computer-processed transactions for the 140 journal voucher adjustments, totaling \$9.4 billion (absolute value), made by the Departmental Accounting Directorate to the source file data. Although the unadjusted source file data were unreliable, the computer-processed adjustments were verified to the journal vouchers.

Audit Period and Standard. We performed this financial-related audit from August 1997 through August 1998. The audit was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included such tests of management controls as were 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, "Internal 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 the Management Control Program. We reviewed the adequacy of management controls over the reporting of the FY 1997 Army WCF Financial Statements. Specifically, we reviewed the management controls over the adequacy of consolidating the status of appropriations data and the general ledger data for the preparation of the Army WCF financial statements. We reviewed management's self-evaluation applicable to those controls.

Adequacy of Management Controls. Management controls did not ensure that information on the financial statements was accurate and reliable. We identified material internal control weaknesses, as defined by DoD Directive 5010.38, in the consolidation of data for preparation of the Army WCF financial statements. Lack of an integrated general ledger system made the financial statements less reliable, particularly for the proprietary accounts. Also, accounting adjustments to the financial statements were not always supported with audit trails to the documented transactions, and footnote disclosures were not adequate. See Part I for a discussion of the internal control weaknesses that we identified and our recommendations for improvement.

Adequacy of Management's Self-Evaluation. We reviewed internal management controls within the Directorate of Departmental Accounting. Personnel at the DFAS Indianapolis Center had identified assessable units and had performed a self-evaluation of internal controls. However, management had not performed a self-evaluation of the branch that consolidates the financial statements. The Internal Control coordinator stated that this branch did not perform a self-evaluation because it had recently been reorganized. As a result, the Annual Statement of Assurance for FY 1997 did not identify accounting adjustments and footnote disclosures as material weakness on the Army WCF financial statements.

Summary of Prior Coverage

Inspector General, DoD, Report No. 98-105, "Inspector General, DoD, Oversight of the Army Audit Agency Audit of the FY 1997 Army Working Capital Fund Financial Statements," April 7, 1998.

Inspector General, DoD, Report No. 94-168, "Defense Finance and Accounting Service Work on the Army's FY 1993 Financial Statements," July 6, 1994.

U. S. General Accounting Office Report No. AFMD-92-83 (OSD Case No. 8674), "Financial Audit: Examination of the Army's Financial Statements for Fiscal Year 1991," August 7, 1992.

Appendix B. Year-To-Year Variances

The FY 1997 Army Working Capital Fund financial statements contained 16 lines with large variances (the change from FY 1996 to FY 1997 was greater than \$30 million and at least 25 percent). The 16 lines are listed below.

FY 1997 Material Year-to-Year Variances (Dollars in Thousands)			
Statement of Financial Position			
Accounts	FY 1997	FY 1996	Change (percent)
X Fund Balance With Treasury	\$ 405,841	\$ 624,162	(34.98)
X Accounts Receivable, Net	278,538	194,706	43.06
X Operating Materials and Supplies	148,798	219,871	(32.32)
Accounts Payable (Federal)	373,277	165,191	125.97
X Other Federal Liabilities (Funded)	488,129	688,079	(29.06)
Accounts Payable (Non-Federal)	308,338	490,786	(37.17)
X Pensions and Other Actuarial Liabilities	128,876	48,886	163.63
X Other Non-Federal Liabilities	387,128	3,017	12,731.55
X Cumulative Results of Operations	(3,453,717)	(633,520)	445.16
X Future Funding Requirements	(516,004)	(51,903)	894.17
Statement of Operations (and Changes in Net Position)			
Revenues From Sale of Goods (to Public)	68,118	424,179	(83.94)
X Other Revenues and Financing Sources	146,513	(10,425)	(1,505.40)
X Cost of Goods or Services Sold (to Public)	73,479	154,784	(52.53)
X Adjustments	(1,436,160)	1,239,614	(215.86)
Excess (Shortage) of Revenues and Financing Sources Over Total Expense	(1,813,972)	221,846	(917.67)
X Plus (Minus) Non-Operating Changes	2,021,750	(382,801)	(628.15)
"X" indicates lines that required additional explanation in the footnotes.			

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
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

Defense Organizations

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

Non-Defense Federal Organizations and Individuals

Inspector General, Department of Education
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 National Security
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs and Criminal Justice
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight

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