Audit Report

COMPILATION OF THE NAVY WORKING CAPITAL FUND FY 1997 FINANCIAL STATEMENTS AT THE DEFENSE FINANCE AND ACCOUNTING SERVICE CLEVELAND CENTER

Report Number 99-005 October 5, 1998

Office of the Inspector General
Department of Defense

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Acronyms

ASN (FM&C)	Assistant Secretary of the Navy (Financial Management and Comptroller)
CDB	Central Data Base
CFO	Chief Financial Officer
DFAS	Defense Finance and Accounting Service
OMB	Office of Management and Budget
NAS	Naval Audit Service
WCF	Working Capital Fund

INSPECTOR GENERAL
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October 5, 1998

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

SUBJECT: Audit Report on Compilation of the Navy Working Capital Fund FY 1997 Financial Statements at the Defense Finance and Accounting Service, Cleveland Center (Report No. 99-005)

We are providing this final report for review and comments. We considered management comments on the draft report when preparing the final report. The audit was performed to meet the requirements of the Chief Financial Officers Act of 1990 for financial statement audits.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Assistant Secretary of the Navy (Financial Management and Comptroller) provided comments on the draft report that were responsive. The Defense Finance and Accounting Service did not comment on the draft report. We request that the Defense Finance and Accounting Service provide comments on the final report by November 4, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Brian Flynn at (703) 604-9145 (DSN 664-9145) (bflynn@dodig.osd.mil) or Mr. Joel K. Chaney at (216) 522-6091, extension 235 (DSN 580-6091) (jchaney@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. 99-005 **October 5, 1998**
(Project No. 7FI-2035.02)

Compilation of the Navy Working Capital Fund FY 1997 Financial Statements at Defense Finance and Accounting Service Cleveland Center

Executive Summary

Introduction. This audit is required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. The Inspector General, DoD, delegated the audit of the Navy Working Capital Fund FY 1997 Financial Statements to the Naval Audit Service. We assisted the Naval Audit Service by performing audit work at the Defense Finance and Accounting Service (DFAS) Cleveland Center. The DFAS Cleveland Center consolidated the financial information for Navy and Marine Corps and compiled the financial statements for the Department of the Navy. The Naval Audit Service was unable to render an opinion because the Navy Working Capital Fund and its accountant, the DFAS, did not provide sufficient information to evaluate the management assertions reported in the Navy Working Capital Fund Consolidated Financial Statements. We concurred with the Naval Audit Service. (For details, see the Naval Audit Service report "Fiscal Years 1997 and 1996 Consolidated Financial Statements of the Department of the Navy Working Capital Fund," February 27, 1998.)

Audit Objectives. The overall audit objective was to determine whether the DFAS Cleveland Center consistently and accurately compiled financial data from Navy field activities, DFAS operating locations and other sources into the FY 1997 principal financial statements of the Navy Working Capital Fund. We evaluated the processes, internal controls, and methods that the DFAS Cleveland Center used to compile the financial statements. We also evaluated the DFAS Cleveland Center management control program related to the compilation of the financial statements.

Audit Results. The DFAS Cleveland Center accurately consolidated financial data and compiled financial statements for each of the Industrial and Service Business Areas of the Navy Working Capital Fund. The DFAS Cleveland Center made significant progress in the compilation processes since FY 1995 (the last time we reported on the compilation processes). However, the DFAS Cleveland Center had not updated its procedures and documented the audit trails and crosswalks used to compile the financial statements (Finding A).

The overview and notes to the FY 1997 Navy Working Capital Fund Financial Statements did not disclose:

- the effect of a major change in accounting practice and reporting methodology for $1.3 billion in undistributed collections and disbursements;

- the effect of the correction of a $3.9 billion understatement of Inventory on the FY 1996 financial statements; or

- the effects of a change in the reporting entity because the Defense Automated Printing Service was transferred to the Defense Logistics Agency in FY 1997.

In addition, the notes did not provide supplemental information related to the $33.1 million abnormal balance reported in the Accounts Payable, Non-Federal line item. As a result, the financial statements may be misunderstood or misinterpreted by users. (Finding B). Details of the audit results are in Part I.

The management controls we reviewed were effective in that no material management control weakness was identified. See Appendix A for details on the management control program.

Summary of Recommendations. We recommend that the DFAS Cleveland Center include the information necessary to compile the financial information for the notes to the financial statements in its published footnote crosswalk; and update its standard operating procedures to identify the activities comprising each Industrial and Service Business Area. For the final report, we added a recommendation to the DFAS Cleveland Center that was not in the draft report that it provide information to the ASN(FM&C) to adequately disclose the effect of changes in accounting and reporting methodology, the effect of correcting errors in prior financial statements, and deviations from DoD accounting policy. We also recommend that the ASN(FM&C) follow OMB and DoD guidance for disclosure of supplemental information in the notes to the financial statements, and obtain technical assistance from the DFAS for determining disclosure requirements.

Management Comments. The ASN(FM&C) agreed to coordinate with and obtain technical assistance from the DFAS Cleveland Center to ensure that future CFO financial statement footnotes provide adequate disclosure of major changes in accounting practices and reporting methodology, significant correction of errors in prior year financial statements, effects of changes in the reporting entity, and abnormal balances. The ASN(FM&C) also agreed to obtain technical assistance from the DFAS Cleveland Center regarding the reporting of deviations from DoD policy in the footnotes to the financial statements. The ASN(FM&C) requested that we take action to ensure that draft DoD policy, currently under consideration, is in agreement with OMB policy in relation to the restating of prior year balances. See Part I for a complete discussion of management comments and Part III for the complete text of management comments.

Audit Response. We considered comments from the ASN(FM&C) responsive to the recommendations. As a result of the comments, we revised the report where appropriate and we provided comments on the draft DoD Financial Management Regulation, currently under consideration, recommending that it be consistent with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements" and require restatement of prior year balances as the result of changes in the reporting entity.

The Director, Defense Finance and Accounting Service, did not comment on the draft report. Therefore, we request the Director, Defense Finance and Accounting Service, provide comments on the final report by November 4, 1998.

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Part I - Audit Results

Audit Background

Chief Financial Officers Act. Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990, requires the preparation of annual financial statements for Government agencies and for trust funds, revolving funds, and substantial commercial activities of Executive departments and agencies. Public Law 103-356, "Federal Financial Management Act of 1994," October 13, 1994, requires the Inspector General, or appointed external auditors, to audit the financial statements in accordance with the Generally Accepted Government Auditing Standards.

Defense Finance and Accounting Service. The Defense Finance and Accounting Service (DFAS) was established in January 1991. DFAS is chartered to standardize and consolidate DoD accounting and finance operations formerly carried out by the various DoD organizations and Military Departments.

The DFAS Cleveland Center. DFAS is the accountant for the Department of the Navy Working Capital Fund (WCF). The DFAS Cleveland Center prepared the Navy WCF Financial Statements using both consolidated and unconsolidated financial data from field-level organizations. The DFAS Cleveland Center prepares and analyzes monthly, quarterly, and annual financial statements and reports. The compilation process was complicated by the fact that the data submitted to the DFAS Cleveland Center were not generated by integrated, transaction-driven, standard general ledger systems. As a result, the DFAS Cleveland Center used a complex process to compile the Navy statements from financial information provided by a variety of accounting subsystems and feeder systems.

At the DFAS Cleveland Center, the Supply Management Branch consolidated the financial data for the Navy Supply Management and Marine Corps Supply Management business areas, and the Industrial Activities Branch compiled the financial data for the Navy Industrial and Service Business Areas and consolidated it with the data for the Marine Corps Depot Maintenance Business Area. The DFAS Cleveland Center used the Central Data Base (CDB) to compile the financial data and produce monthly and annual financial statements.

Audit Objectives

The overall audit objective was to determine whether the DFAS Cleveland Center consistently and accurately compiled financial data from Navy field activities, DFAS operating locations, and other sources into the FY 1997 principal financial statements of the Navy Working Capital Fund. We evaluated the processes, internal controls, and methods that the DFAS Cleveland Center used to compile the FY 1997 Consolidated Financial Statements of the Navy Working Capital Fund. We also evaluated the DFAS Cleveland Center management control program for compiling the financial statements. In addition, we determined

whether the disclosure of supplemental financial information in the overview and notes to the financial statements complied with Office of Management and Budget and DoD guidance.

See Appendix A for a discussion of the scope and methodology related to this audit and discussion of the DFAS Cleveland Center management control program. In addition, see Appendix A for a summary of prior coverage related to the audit objectives.

Finding A. Compiling the FY 1997 Navy Working Capital Fund Financial Statements

The DFAS Cleveland Center accurately consolidated financial data and compiled financial statements for each of the Industrial and Service Business Areas of the Navy WCF. DFAS Cleveland Center had improved its controls over the compilation process since our review of the process used to compile the FY 1995 Navy Defense Business Operations Fund Financial Statements. However, the DFAS Cleveland Center needs to improve documentation of the audit trails used in compiling the financial statements. The crosswalks used to compile financial data for the notes to the financial statements were not complete. In addition, the DFAS Cleveland standard operating procedures did not provide guidance for combining activities to compile business area trial balances. The guidance for the activities in each business area was outdated. While the FY 1997 financial statements were not misstated, the documentation of audit trails used in compiling the statements would provide greater assurance that the FY 1998 financial statements will be consistently and accurately prepared.

Criteria for Compiling Financial Statements

DoD Regulation 7000.14-R, the "DoD Financial Management Regulation," volume 6, "Form and Content of Audited Financial Statements," January 1998, states that the Director, DFAS, should establish procedures to ensure that the process for preparing financial reports is consistent, timely, and auditable. The Regulation also stated that controls should be in place to ensure accurate reporting, and that adequate audit trails should be created to allow transactions to be traced through a system.

Compilation of Financial Information for Industrial and Service Business Areas

We reviewed the consolidation and adjustment of financial information submitted to the DFAS Cleveland Center for the Industrial and Service Business Areas of the Navy WCF. Financial information was received from DFAS Operating Locations, Navy field activities, and other sources. The Industrial and Service Business Areas were accountable for about $10 billion of the $23.9 billion in Navy WCF assets. The DFAS Cleveland Center accurately consolidated that financial information and prepared trial balances for each of the Industrial and Service Business Areas. The DFAS Cleveland Center adjusted those trial balances for errors in the financial information submitted by the activities, and adjusted the general ledger account balances for funds collected and disbursed so

that the general ledger would agree with the Centralized Expenditure and Reimbursement Processing System. For the line items reviewed, the DFAS Cleveland Center processed 26 adjustments totaling $1.2 billion. Those adjustments were generally supported by documentary evidence. However, for one adjustment, involving $170,000, the DFAS Operating Location did not provide the supporting documentation.

DFAS Cleveland Center Procedures

The procedures used by DFAS Cleveland Center for preparation of the financial statements did not include accurate guidance for compiling the financial data presented in the notes to the financial statements or for compiling undistributed collections and disbursements.

Procedures for Compiling Information Presented in the Notes to the Financial Statements. We reviewed the compilation of financial information included in the footnotes to the Statement of Financial Position. Our review focused on the following footnotes and the financial information reported by both the Industrial and Services Business Areas and the Supply Management Business Area:

- Note No. 2, Fund Balance With Treasury;
- Note No. 5, Accounts Receivable, Net – Intragovernmental;
- Note No. 5, Accounts Receivable, Net – Governmental;
- Note No. 8, Inventory, Net;
- Note No. 10, Operating Materials and Supplies;
- Note No. 15, Property, Plant and Equipment, Net;
- Note No. 17, Other Federal (Intragovernmental) Liabilities;
- Note No. 17, Other Non-Federal (Governmental) Liabilities; and
- Note No. 20, Net Position.

The procedures did not state how financial information was compiled for the notes to the financial statements. DFAS Cleveland Center personnel provided us with crosswalks that identified the General Ledger Accounts with the amounts reported in the footnotes for each line item reviewed. We accumulated the values from the trial balances provided by the DFAS Cleveland Center and compared our results to the amounts reported in the footnotes for these line items. Initially, we could not substantiate the amounts disclosed in the footnotes for four of the seven footnotes reviewed. We obtained additional instructions and information from the DFAS Cleveland Center for the following four footnotes: Fund Balance with Treasury; Other Federal (Intragovernmental) Liabilities; Accounts Receivable (Governmental), Net; and Net Position. With the additional instructions and information, we substantiated the amounts reported. The footnote crosswalks did not include the additional data necessary to document the audit trail used to compile information for the notes to the financial statements.

Procedures for Compiling Undistributed Collections and Disbursements. The DFAS Cleveland Center's standard operating procedures did not address how undistributed collections and disbursements were compiled in the Industrial and

Service Business Area trial balances. For a detailed list of the Industrial and Service Business Areas, see Appendix B. In the absence of formal procedures, we interviewed DFAS Cleveland personnel to determine the procedures for compiling the undistributed collections and disbursements. To test the accuracy of the undistributed collection and disbursement data, we tried to recreate the amounts reported on the business area trial balances. We used a list of current activities and the "DBOF Activity Control Ledger Trial Balance, September 1997," to determine which activities were included in the trial balance for each business area. Initially, we were not able to substantiate the undistributed collection and disbursement amounts reported in the business area trial balances. We obtained additional information from DFAS Cleveland Center, which accurately identified the activities in each business area. With that guidance, we substantiated the amounts reported for each business areas. The standard operating procedures did not include sufficient guidance defining the audit trail for compiling the undistributed collections and disbursements.

Other Compilation Issues

The Inspector General, DoD, delegated the audit of the FY 1997 Navy WCF Financial Statements to NAS. In support of the NAS audit, we examined certain processes that the DFAS Cleveland Center used to compile the FY 1997 Navy WCF financial statements. The following are compilation issues that the NAS reported in Draft Audit Report No. 98-0099, "Fiscal Years 1997 and 1996 Consolidated Financial Statements of the Department of the Navy Working Capital Fund: Reportable Conditions," March 10, 1998.

Finding No. 6, "Inventory, Net." NAS reported that the inventory value on the financial statements was overstated by $242.5 million because War Reserves were misclassified as inventory. DoD Regulation 7000.14-R, volume 6, chapter 6, states that War Reserves should be reported on line 1.l of the Statement of Financial Position. NAS recommended that the ASN (FMC) and the Director, DFAS, prepare a summary journal voucher to increase the FY 1997 Navy Working Capital Fund Consolidating Financial Statement balance for War Reserves by $242,488,000.

Finding No. 12, "Other Federal (Intragovernmental) Liabilities for Industrial-Type Activities." NAS reported that the amount of Other Federal (Intragovernmental) Liabilities reported on the FY 1997 Department of the Navy Working Capital Fund Consolidated Financial Statements for industrial-type activities contained net balances for Undistributed Collections and Disbursements, totaling $1,256,899,000, that should have been transferred to Accounts Receivable and Accounts Payable. DoD Regulation 7000.14-R, volume 11B, chapter 54, states that balances remaining in Undistributed Collections and Disbursements after research will be transferred to Accounts Receivable, Federal and Non-Federal, and Accounts Payable, Federal and Non-Federal. NAS recommended that the Director, DFAS, transfer balances remaining after research from Undistributed Collections and Disbursements to Accounts Receivable,

Federal and Non-Federal and Accounts Payable, Federal and Non-Federal to adjust The FY 1997 Navy Working Capital Fund Consolidated Financial Statements.

Finding No. 23, "Intrafund Eliminations." NAS reported that footnote No. 29, "Intrafund Eliminations," on the FY 1997 Navy Working Capital Fund Consolidated Financial Statements, did not include all intrafund elimination transactions, as required by DoD guidance. At least $24.9 million of Accounts Receivable and Accounts Payable should have been reported. The Department of the Navy WCF did not report amounts for these accounts because systems and policies that would identify intrafund transactions were not fully developed. NAS recommended that the ASN (FMC) and Director, DFAS, develop uniform procedures to identify the information needed for Footnote No. 29, "Intrafund Eliminations."

Because NAS has already made recommendations on these compilation issues, we are making no further recommendations.

Summary

The DFAS Cleveland Center accurately consolidated and compiled the financial statements for each of the Industrial and Service Business Areas of the Navy WCF. However, management controls in the form of documented audit trails were not sufficient. To substantiate the amounts reported in the footnotes to the financial statements and to substantiate undistributed collections and disbursements for each of the Industrial and Service Business Areas, we had to obtain additional guidance. While the financial data were accurately compiled, the standard operating procedures and documentation of audit trails warrant attention from the DFAS Cleveland Center.

Recommendations for Corrective Action

A.1. We recommend that Defense Finance and Accounting Service Cleveland Center include all information necessary to compile financial information for the notes to the financial statements in the published footnote crosswalk.

A.2. We recommend that Defense Finance and Accounting Service Cleveland Center update its standard operating procedures to identify how undistributed collections and disbursements amounts are compiled and to identify the activities in each Industrial and Service Business Area of the Navy Working Capital Fund.

Management Comments Required

The DFAS did not comment on a draft of this report. We request that the DFAS provide comments on the final report.

Finding B. Footnote Disclosures for the FY 1997 Navy Working Capital Fund Financial Statements

The overview and notes in the FY 1997 Navy WCF Financial Statements did not disclose:

- the effect of a major change in accounting practice and reporting methodology for $1.3 billion in undistributed collections and disbursements;
- the effect of the correction of a $3.9 billion understatement of Inventory on the FY 1996 financial statements; or
- the effects of a change in the reporting entity because the Defense Automated Printing Service was transferred to the Defense Logistics Agency in FY 1997.

In addition, the notes did not provide supplemental information related to the $33.1 million abnormal balance reported in the Accounts Payable, Non-Federal line item. The inadequate footnote disclosures occurred because the ASN (FMC) did not follow OMB and DoD guidance for disclosure of supplemental information. As a result, the notes to the FY 1997 Navy WCF Financial Statements did not contain complete explanations, nor could comparisons be made to FY 1996 reported balances. The inadequate disclosures could result in erroneous assumptions and misinterpretations by users of the financial statements.

Guidance and Responsibilities for Footnote Disclosures

The Federal Accounting Standards Advisory Board "Statement of Federal Financial Accounting Concepts No. 1," September 2, 1993, discusses consistency and comparability in financial accounting and reporting. The accounting concepts require financial reports to be consistent over time; once an accounting principle or reporting method is adopted, it should be used for all similar transactions and events unless there is good cause to change. If the accounting principles or the financial reporting entity have changed, the nature and reasons should be disclosed. In addition, the accounting concepts state that differences among financial reports should be caused by substantive differences in the underlying transactions or organizations, not by differences in accounting procedures or practices.

The "Statement of Federal Financial Accounting Concepts No. 2," August 23, 1993, states that financial information is also conveyed with accompanying footnotes, which are an integral part of the financial statements. Footnotes provide additional disclosures necessary to make the financial statements more informative and not misleading.

DoD Regulation 7000.14-R, volume 6, chapter 6 specifies that once departmental records have been closed and audited financial statements published, no changes can be made to prior year line item balances or statement totals without the written approval of the DoD Chief Financial Officer (CFO) or Deputy CFO. DoD Regulation 7000.14-R also provides that all abnormal balances must be explained in a note associated with the specific line or in Note 31, Other Disclosures.

The DFAS Cleveland Center and the ASN (FMC) shared responsibilities for the information disclosed in the notes to the financial statements. The DFAS Cleveland Center was responsible for the tables that presented the financial information required by DoD Regulation 7000.14-R. The ASN (FMC) was responsible for the other information provided in the notes. This information was generally developed by consolidating information from Navy management commands. The "Fiscal Year 1998 DFAS Cleveland Center Year-End CFO Guidance" made DFAS Cleveland Center responsible for reviewing and analyzing data submitted by customers including the identification and reporting of practices that deviate from DoD Regulation 7000.14-R in the notes to the financial statements.

Footnote Presentation and Disclosure

The notes to the FY 1997 Navy WCF Consolidated Financial Statements generally followed guidance established in DoD Regulation 7000.14-R, volume 6. However, the notes did not consistently or completely disclose:

- changes in accounting practices and reporting methodology,
- correction of errors in prior year financial statements,
- changes in the reporting entity, and
- the abnormal balance reported for the Accounts Payable, Non-Federal line item.

Change in Accounting Practice and Reporting Methodology. The ASN (FMC) and DFAS did not comply with DoD guidance for the presentation of undistributed collections and disbursements, and the notes to the financial statements did not adequately disclose the accounting practices and reporting methodology that was adopted.

DoD Regulation 7000.14-R, volume 11B, "Reimbursable Operations, Policy and Procedures - Defense Working Capital Fund," states that before preparation of the financial statements, the remaining values in undistributed collections and disbursements should be transferred to Accounts Receivable and Accounts Payable. Undistributed collections and disbursements represent the differences between the U.S. Treasury and the Navy WCF activities' account balances for cash collections and disbursements. Some of the differences result when the activities record transactions before the transactions are reported to the U.S.

Treasury. In other cases, transactions are recorded by the U.S. Treasury, but have not been recorded in the activities' accounting records because of inherent delays in processing the transaction and because transactions cannot be immediately identified to the responsible activity.

In its report, "Fiscal Year 1997 and 1996 Consolidated Financial Statements of the Department of the Navy Working Capital Fund: Reportable Conditions," the Naval Audit Service (NAS) reported that Other Federal (Intragovernmental) Liabilities was understated by about $1.3 billion and Accounts Receivable and Accounts Payable were misstated because the DFAS Cleveland Center transferred the net of undistributed collections and disbursements to Other Federal (Intragovernmental) Liabilities. These misstatements occurred because DFAS did not comply with DoD Regulation 7000.14, volume 11B.

Headquarters, DFAS, directed the DFAS Cleveland Center to transfer the net of undistributed collections and disbursements to Other Federal (Intragovernmental) Liabilities instead of Accounts Receivable and Accounts Payable; and to disclose the change in accounting treatment, including the reason for the change and its effect on FY 1996 and FY 1997 account balances in the notes to the Statement of Financial Position.

The DFAS Cleveland Center did not implement the accounting practice on a consistent basis. The DFAS Cleveland Center followed Headquarters, DFAS guidance for the Industrial, Service, and Component Business Areas. Net undistributed collections and disbursements, totaling approximately $1.3 billion, were presented as Other Federal (Intragovernmental) Liabilities. However, the DFAS Cleveland Center followed DoD Regulation 7000.14-R for the Supply Management Business Area. For the Supply Management Business Area, the DFAS Cleveland Center allocated and transferred the undistributed collections, $587.3 million, and undistributed disbursements, $411.5 million, to Accounts Receivable, Federal and Non-Federal, and to Accounts Payable, Federal and Non-Federal. The inconsistent application of DoD Regulation 7000.14, volume 11B, and the Headquarters, DFAS, guidance further distorted the FY 1997 Navy WCF Consolidated Financial Statements. The FY 1997 financial statements were not prepared and presented consistently.

The adoption of the changed accounting practice was not accurately disclosed in the financial statements. The overview to the financial statements discussed the reason for the change. However, the overview erroneously reported that because of abnormal balances of undistributed collections and disbursement, the undistributed collections and disbursements were transferred to Other Entity Assets, line 1.A.(6). In addition, the notes to the financial statements did not disclose the change in accounting practice or its effect on the FY 1997 Navy WCF Financial Statements in Note 1, Significant Accounting Policies; Note 5, Accounts Receivable; Note 17, Other Federal (Intragovernmental) Liabilities; or Note 31, Other Disclosures.

Correction of Errors in Prior Year Financial Statements. The notes to the financial statements did not provide adequate disclosure about the correction of a material error in the FY 1996 Navy WCF Consolidated Financial Statements.

Inventory, Net, was understated by approximately $3.9 billion. Additionally, Invested Capital and Cumulative Results of Operations were understated by $1.7 billion and $2.2 billion, respectively.

The Under Secretary of Defense (Comptroller), ASN (FMC), DFAS Cleveland Center, and NAS established a working group to evaluate the model used to value inventory and calculate the cost of goods sold. The objective of the working group was to establish a sound model to revalue inventory to historic cost and to calculate cost of goods sold. The working group determined that Inventory, Net, was understated by approximately $3.9 billion in the FY 1996 financial statements. The understatement of Inventory, Net resulted from the erroneous application of the model and changes to the logic used for valuing inventory. The model did not accurately account for unreimbursed transfers and repair expenses. During FY 1997, the DFAS Cleveland Center recorded a prior period adjustment to correct the error.

The correction was not adequately disclosed in the overview and notes to the Financial Statements. OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," provides that, when prior period adjustments are material and represent the correction of an error in previously issued statements, disclosure should include the effects for each of the periods included in the statements. The ASN (FMC) provided partial disclosure of the correction in the overview and notes to the financial statements. However, those disclosures did not adequately describe the nature of the error or its impact on FY 1996 Operating Results. In addition, the disclosure did not adequately identify the effect of the prior period adjustment on Invested Capital and Cumulative Results of Operations for FY 1997.

Changes in Reporting Entity. The notes to the financial statements did not adequately disclose the impact of a change in the reporting entity when the Defense Automated Printing Service activity group was transferred to the Defense Logistics Agency.

OMB Bulletin No. 94-01 provides that when adjustments are material and represent an accounting change or a correction of an error in previously issued statements, the adjustment should, in single period statements, be reflected as an adjustment of the opening balance of net position. When comparative statements are presented, the disclosure should include the effects for each of the periods included in the statements.

OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," is effective for FY 1998. The bulletin clarifies previous guidance for the reporting and disclosure of changes in the reporting entity. It states that such changes result in a new reporting entity, and the impact should be reported by restating the financial statements for all prior periods presented to show the new reporting entity for the periods.

The overview to the financial statements disclosed that the Defense Automated Printing Service was transferred to the Defense Logistics Agency. However, the effect of change on the comparative financial statements was not disclosed in either the overview or notes to the financial statements. The FY 1996 financial

statements for major business areas of the Navy WCF, which were not published as part of the Consolidated Financial Statements, showed that the Defense Automated Printing Service was a major business segment of the Navy WCF.

Abnormal Balances. The notes to the financial statements did not adequately disclose the abnormal balance reported in the Accounts Payable, Non-Federal, line of the FY 1997 Navy WCF Consolidated Financial Statements.

DoD Regulation 7000.14-R, volume 6, requires all abnormal balances to be explained in a note associated with the specific line or in Note 31, Other Disclosures. The regulation does not require a specific footnote for Accounts Payable; therefore the abnormal balance should have been disclosed in Note 31.

The DFAS Cleveland Center guidance, "Year End Closing Guidance for FY 1997 for General Funds & Navy Working Capital Funds," made the Navy management commands responsible for Note 31, Other Disclosures. The ASN (FMC) consolidated information from the management commands and prepared the information in Note 31.

Note 31, Other Disclosures, did not provide supplemental information on the nature of the abnormal balance. The abnormal balance reported for Accounts Payable, Non-Federal, was $33.1 million. The abnormal balance occurred in part because general ledger balances for Unallocated Costs – Unmatched and Unallocated Costs - Bank Card Accounts were transferred to Accounts Payable, Non-Federal for reporting purposes. The unallocated cost accounts are a normal debit balance; therefore, they reduced the accounts payable balance and created an abnormal balance.

Summary

The ASN (FMC) did not always provide adequate disclosure in the overview and the notes to the financial statements. The overview and the notes to the financial statements did not adequately disclose a major change in reporting methodology, the correction of an error in prior year financial statements, nor the change in the reporting entity. In addition, the notes to the financial statements did not disclose the abnormal line item balance for Accounts Payable, Non-Federal. The ASN (FMC) needs to adequately explain when changes in accounting practices and corrections of errors in prior years cause the prior year financial information to be inconsistent with information for the current year.

Recommendations, Management Comments, and Audit Response

B.1. We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) follow Office of Management and Budget and DoD guidance for disclosure of supplemental financial information in the notes to the Department of the Navy Working Capital Fund Financial Statements.

Management Comments. The ASN (FMC) concurred with the recommendation and stated that the ASN (FMC) will coordinate with the DFAS Cleveland Center to ensure that future CFO financial statement footnotes provide adequate disclosure of major changes in accounting practices and reporting methodology, significant correction of errors in prior year financial statements, effects of changes in the reporting entity, and abnormal balances. The ASN (FMC) requested that the IG, DoD, ensure that draft DoD Financial Management Regulation, currently under consideration, be revised to be consistent with OMB policy regarding the restating of prior year balances as the result of a change in the reporting entity.

Audit Response. Management comments were responsive. The actions proposed by the ASN (FMC) satisfy the intent of the recommendations. We provided comments on the draft DoD Financial Management Regulation, currently under consideration, recommending that it be consistent with OMB Bulletin No. 97-01, Form and Content of Agency Financial Statements" and require restatement of prior year balances as the result of changes in the reporting entity.

B.2. We recommend that the Assistant Secretary of the Navy, (Financial Management and Comptroller) obtain technical assistance from the Defense Finance and Accounting Service for determining disclosure requirements.

Management Comments. The ASN (FMC) concurred in principle. The ASN (FMC) will obtain technical assistance from the DFAS Cleveland Center for determining footnote disclosure requirements for deviations from DoD policy, major changes in accounting practices and reporting methodology, the correction of significant errors in prior year financial statements, the effects of changes in the reporting entity, and abnormal balances. The ASN (FMC) indicated there is no need to request technical assistance from DFAS for analyzing financial trends. DoD policy requires DFAS to perform trend analysis and advise the Navy of unusual trends and comparisons with prior year or prior period amounts for appropriate action or analysis by customers.

Audit Response. Management comments were responsive. We revised the recommendation concerning the analysis of financial trends. The actions proposed by the ASN (FMC) satisfy the intent of the recommendations.

B.3. We recommend that the Defense Finance and Accounting Service provide the Assistant Secretary of the Navy (Financial Management and Comptroller) information for the narrative portion of the notes to the financial statements to adequately disclose the effect of changes in accounting and reporting methodology, the effect of correcting errors in prior financial statements, and deviations from DoD accounting policies.

Management Comments. This recommendation was added to the final report as a result of discussions of the draft report with ASN (FM&C) and the DFAS Cleveland Center.

Management Comments Required

We request that the DFAS provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope and Methodology

Work Performed. We examined the DFAS Cleveland Center's processes for compiling financial data to produce the FY 1997 Navy WCF Consolidated Financial Statements. The DFAS Cleveland Center consolidated field-level data to prepare the FY 1997 Navy WCF Consolidated Financial Statements, version 2, submitted to us December 23, 1997. Our review concentrated on, but was not limited to, the compilation of the material line items for the Industrial and Services Business Areas. The table below compares the values reported in FYs 1996 and 1997 for the line items reviewed.

Percentage Change in Balance from FY 1996 to FY 1997 of Line Items Reviewed (in thousands)

	Line Item	FY 1997 Balance	FY 1996 Balance	Percent Change
1.a.1	Fund Balance With Treasury	$ 746,524	$ 1,905,994	-60.83%
1.a.3	Accounts Receivable, Federal	1,193,817	2,437,997	-51.03%
1.a.5.	Advances and Prepayments	147,792	108,363	36.39%
1.b.2.	Accounts Receivable, Non-Federal	285,531	1,610,544	-82.27%
1.d.	Inventory, Net	13,145,216	10,528,953	24.95%
1.f.	Operating Materials, Supplies	592,074	626,613	-5.51%
1.k.	Property, Plant, and Equipment	4,623,668	4,534,689	1.96%
4.a.1.	Accounts Payable, Federal	844,275	1,844,117	54.22%
4.a.4	Other Federal Liabilities	1,383,055	3,512,162	-60.62%
4.b.1.	Accounts Payable, Non-Federal	(33,134)	329,749	-110.05%
4.b.7.	Other Non-Federal Liabilities	2,941,801	3,060,717	-3.89%

We reviewed processes used to transfer and consolidate activity-level data in the CDB into the business area trial balances for all Industrial and Services Fund activities. This included crosswalking each activity's Department of the Navy Industrial Business Information System general ledger accounts into the CDB standard general ledger accounts and consolidating the CDB standard general ledger account amounts for all activities in each business area. The amounts we computed for each business area were compared to the CDB standard general ledger account in the CDB - produced trial balances for the business areas. Any differences were presented to the DFAS Cleveland Center for explanation and supporting documentation.

We reviewed DFAS Cleveland Center's processes for transferring trial balance data on the Industrial and Service business areas to the business area financial statements. This included crosswalking the CDB standard general ledger accounts to financial statement line items, using the crosswalk provided by the DFAS Cleveland Center. We also examined the DFAS Cleveland Center's processes for consolidating all business area financial statements into the FY 1997 Navy WCF Consolidated Financial Statements.

We reviewed the DFAS Cleveland Center's process for compiling financial information for the notes to the financial statements. In addition, we reviewed the adequacy of supplemental financial information provided in the overview and notes to the financial statements to determine whether the disclosures provided by the ASN (FMC) and the DFAS Cleveland Center complied with OMB and DoD guidance.

Use of Computer-Processed Data. We relied on computer-processed data from numerous field-level accounting systems to evaluate the compilation of the FY 1997 Navy WCF Consolidated Financial Statements. We did not test the reliability of the data from those accounting systems. Our audit focused on the DFAS Cleveland Center processes used to consolidate the field-level accounting data and compile the financial statements. However, the Naval Audit Service audited data from the field-level accounting systems and identified inaccuracies. These data inaccuracies do not change the conclusions reached in this report.

DoD-wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to the achievement of the following objectives and goals:

Objective: Fundamentally reengineer the Department 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 area objectives and goals.

- **Financial Management Functional Area Objective:** Strengthen internal controls. **Goal**: Improve compliance with the Federal Financial Management Improvement Act. **(FM-5.3)**

- **Financial Management Functional Area. Objective:** Reengineer DoD Business Practices. **Goal**: Standardize, reduce, clarify, and reissue FM policies. **(FM-4.1)**

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

Audit Type, Dates, and Standards. This financial-related audit was conducted from August 1997 through August 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

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

Summary of Prior Coverage

IG, DoD, Report No. 97-062, "Consistency in Reporting the Expense Account Line Items of the Defense Business Operations Fund," January 7, 1997.

IG, DoD, Report No. 97-027, "Defense Finance and Accounting Service Work on the Navy Defense Business Operations Fund FY 1995 Financial Statements," November 22, 1996.

IG, DoD, Report No. 95-294, "Major Accounting Deficiencies in the Defense Business Operations Fund in FY 1994," August 18, 1995.

IG, DoD, Report No. 95-267, "Defense Business Operations Fund Consolidated Statement of Financial Position for FY 1994," June 30, 1995.

NAS Report No. 024-98, "FYs 1997 and 1996 Consolidated Financial Statements of the Department of the Navy Working Capital Fund," February 27, 1998.

NAS Report No. 040-97, "FY 1996 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund," June 16, 1997.

NAS Report No. 044-95, "FY 1994 Consolidating Financial Statements of the Department of the Navy DBOF," May 30, 1995.

Management Control Program

DoD Directive 5010.38, "Management Control 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 controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the DFAS Cleveland Center's management controls over the compilation of the FY 1997 Navy WCF Consolidated Financial Statements. Specifically, we reviewed management controls over the adjustment and compilation of the financial statements.

Adequacy of Management Controls. The DFAS Cleveland Center's management controls over the compilation of the FY 1997 Navy WCF Financial Statements were adequate as they applied to the audit objectives.

Adequacy of Management's Self-Evaluation. The DFAS Cleveland Center's self-evaluation was adequate. The DFAS Cleveland Center established and planned an adequate internal management control program as defined by DoD Directive 5010.38. During FY 1997, the DFAS Cleveland Center performed 153 reviews of various assessable units. All but 11 planned reviews were done on or before the scheduled review date, a significant improvement from the past 2 years. Of those 11 reviews, only 1 could affect the preparation of the FY 1997 Navy WCF Consolidated Financial Statements. This assessable unit dealt with an internal management control review of problem disbursements.

Adequacy of Management's Assessment of Accounting Systems. The CDB, which compiles the Navy WCF Consolidated Financial Statements, receives accounting information from a variety of accounting systems. The CDB System Manager/User Review for FY 1997 was not done because the CDB is scheduled for replacement at the end of FY 1998. The DFAS Cleveland Center FY 1996 System Manager/User Review of the CDB reported that the accounting systems used to prepare the financial statements complied with the Key Accounting Requirements. However, we were unable to determine whether the CDB is in compliance with the Key Accounting Requirements. Additionally, the accounting systems from which the CDB receives data, such as the Defense Industrial Financial Management System and the Material Financial Control System, do not comply with the Key Accounting Requirements. This continues to impede progress in achieving auditable financial statements. We did not review System Manager/User Reviews for automated systems that were not controlled by DFAS.

Appendix B. Working Capital Fund Business Areas

Business Areas	Fund Type
Supply Management (Navy and Marine Corps)	Supply Management
Depot Maintenance	
Aviation	Industrial and Service
Shipyards	Industrial and Service
Ordnance	Industrial and Service
Other, Marine Corps	Industrial and Service
Transportation	Industrial and Service
Base Support	Industrial and Service
Information Services	Industrial and Service
Research and Development	Industrial and Service
Naval Surface Warfare Center	
Naval Air Warfare Center - Aircraft	
Naval Air Warfare Center - Weapons	
Navy Command, Control and Ocean Surveillance Center	
Naval Research Laboratories	
Naval Facilities Engineering Service Center	
Naval Undersea Warfare Center	
Component Level – ASN (FMC)	Industrial and Service

Appendix C. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

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

Department of the Navy

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

Department of the Air Force

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

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
  Director, Defense Finance and Accounting Service Cleveland Center
Director, Defense Logistics Agency
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

Part III. Management Comments

Department of the Navy Comments

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

22 SEP 1998

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Sub: DEPARTMENT OF DEFENSE INSPECTOR GENERAL DRAFT AUDIT REPORT "COMPILATION OF THE NAVY WORKING CAPITAL FUND FISCAL YEAR 1997 FINANCIAL STATEMENTS AT DEFENSE FINANCE AND ACCOUNTING SERVICE - CLEVELAND CENTER" PROJECT NO. 7FI-2035.02 OF 31 AUGUST 1998

Ref: (a) DoDIG memo of 31 Aug 98

Encl: (1) ASN(FM&C) Comments on Draft Audit Report 7FI-2035.02

By reference (a), you requested this office review and comment on the Department of Defense Inspector General (DoDIG) subject draft audit report. Enclosure (1) provides our detailed comments.

The opportunity to revise the Navy Working Capital Fund (NWCF) Fiscal Year (FY) 1997 Chief Financial Officer (CFO) Statement for audit identified deficiencies has passed. However, audit recommended adjustments, which are provided to us prior to the final FY 1998 CFO Statement submission, will allow us to make appropriate corrections.

The Assistant Secretary of the Navy (Financial Management and Comptroller) (ASN(FM&C)), Office of Financial Operations point of contact on this subject is Ms. Linda Tread at (202) 685-6740 or DSN 325-6740.

GLADYS J. COMMONS
Assistant Secretary of the Navy
(Financial Management and Comptroller)
Acting

Copy to:
AUDGEN
NAVAUDSVCEAST
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DFAS
DFAS-CL
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Final Report Reference

ASN(FM&C) COMMENTS ON DRAFT AUDIT REPORT 7FI-2035.02

FINDING B: Footnote Disclosures for the FY 1997 NWCF Financial Statements

COMMENT:

a. The sentence under "Correction of Errors in Prior Year Financial Statements" that states "Inventory, Net was understated by approximately $3.9 billion and Invested Capital and Cumulative Results of Operations were understated by a like amount." is not correct and should be revised. The FY 1996 Cumulative Results of Operations was understated by an amount less than $3.9 billion, as discussed in the published NWCF FY 1997 CFO Annual Financial Statement Note 1.C "Budgets and Budgetary Accounting" and Note 1.R "Equity". Additionally, the "Correction of Errors in Prior Year Financial Statements" section of the draft audit report provides that the disclosure did not adequately describe the nature of the error or its impact on the FY 1996 operating results or the effect of the prior period adjustment on Invested Capital and Cumulative Results of Operations reported for FY 1997. The published NWCF FY 1997 CFO Annual Financial Statement, Note 1.C "Budgets and Budgetary Accounting" and Note 1.R "Equity", disclose that the reported FY 1996 net operating results of ($3,904,937) thousand should have been ($1,724,851) thousand due to a cross check problem encountered by the Defense Finance and Accounting Service (DFAS) when preparing the CFO statements. Those notes also disclose that DFAS-Cleveland Center (CL) has made corresponding correcting entries to the Cumulative Results of Operations. Note 1.C refers to Note 27. The Note 27 "Prior Period Adjustments" narrative, prepared by DFAS-CL for Supply Management (Navy), provides that the $2,131,132 thousand "USD(C) Model Prior Period AOR Adjustment" is a product of the model developed by members of the Under Secretary of Defense (Comptroller) (USD(C)) and DFAS for the Cost of Goods Sold presentation and Inventory Valuation. Therefore, this section of the draft audit report should be revised to recognize these note disclosures.

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Revised Page 11

b. The reference to the Office of Management and Budget (OMB) Bulletin No. 97-01, under "Changes in Reporting Entity" on pages 11 and 12, implies that in future years the reporting entity should restate the prior year column on the current CFO financial statements, to show changes in the reporting entity. This OMB Bulletin No. 97-01 guidance does not appear to be prescribed in the draft DoD Financial Management Regulation (FMR), Volume 6B of August 1998. Therefore, to avoid confusion, recommend you confirm with the USD(C) their intention to adopt that OMB Bulletin No. 97-01 policy for DoD Components, before the final audit report is published.

Revised Executive Summary and Page 14

Enclosure (1)

c. We recommend that the first sentence to the Finding B "Summary" section be changed to read: "The ASN(FM&C) did not always provide adequate disclosure in the notes to the financial statements."

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RECOMMENDATION B.1: We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) follow OMB and DoD guidance for disclosure of supplemental financial information in the notes to the Department of the Navy WCF Financial Statements.

COMMENT: Concur. The ASN(FM&C) will coordinate with DFAS-CL to ensure that future CFO financial statement footnotes provide adequate disclosure of: (1) major changes in accounting practices and reporting methodology, (2) significant correction of errors in prior year financial statements, (3) effects of changes in the reporting entity, and (4) abnormal balances. This action will be completed by the submission of the NWCF FY 1998 CFO Annual Financial Statement on 17 December 1998.

RECOMMENDATION B.2: We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) obtain technical assistance from the Defense Finance and Accounting Service for analyzing financial trends and determining disclosure requirements.

COMMENT: Concur in principle. We agree that the ASN(FM&C) will obtain technical assistance from DFAS-CL for determining footnote disclosure requirements of: (1) deviations from DoD accounting policy, (2) major changes in accounting practices and reporting methodology, (3) significant correction of errors in prior year financial statements, (4) effects of changes in the reporting entity, and (5) abnormal balances. We agree with the DoDIG 3 September 1998 proposed revised wording for the final report Recommendation B.2, as follows: "We recommend that the ASN(FM&C) obtain technical assistance from DFAS for determining disclosure requirements." The deletion of "analyzing financial trends and" is appropriate, since paragraph 020206.B of the DoD FMR, Volume 6, Chapter 2, already requires DFAS to call to the attention of the customer unusual trends and comparisons with prior year and/or prior period amounts for appropriate action or analysis by the customer. This action will be completed by the submission of the NWCF FY 1998 CFO Annual Financial Statement on 17 December 1998.

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Additionally, we agree with the DoDIG 3 September 1998 proposed wording for the following new Recommendation B.3, to be added in the final report: "We recommend that DFAS provide the ASN(FM&C) information for the narrative portion of the notes to the (CFO) financial statements to adequately disclose the effect of (major)

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changes in accounting and reporting methodology, the effect of correcting of errors in prior financial statements, and deviations from DoD accounting policies." This new recommendation is supported by the FY 1998 DFAS-CL Year-End Closing Guidance requirement for DFAS-CL to review and analyze data submitted by their customers. The review includes the identification and reporting of practices that deviate from DoD 7000.14-R in the footnotes to the financial statements or in the Certification Letter accompanying the financial statements. Also, indirectly related is paragraph 020209.B guidance for material prior period adjustments made solely for financial statement presentation purposes and its footnote disclosure of prior period adjustments processed after the report was finalized and the related impacts on the applicable report lines in the prior year column.

EXECUTIVE SUMMARY: Summary of Recommendations

COMMENT: On page ii, we recommend that the last sentence of the "Summary of Recommendations" be changed from "the DFAS for analyzing financial trends . . . requirements" to "the DFAS for determining disclosure requirements." to be consistent with our comments made on Recommendation B.2 above.

Revised Page ii

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Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General of Auditing, DoD.

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