

Audit



Report

DATA SUPPORTING THE DOD ENVIRONMENTAL LINE ITEM
LIABILITY ON THE FY 1998 FINANCIAL STATEMENTS

Report No. 99-209

July 9, 1999

Office of the Inspector General
Department of Defense

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Acronyms

CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
CFO	Chief Financial Officers
CTC	Cost to Complete
SFFAS	Statement of Federal Financial Accounting Standards
USD(C)	Under Secretary of Defense (Comptroller)



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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July 9, 1999

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DEPUTY UNDER SECRETARY OF DEFENSE
(ENVIRONMENTAL SECURITY)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on the Data Supporting the DoD Environmental Line Item
Liability on the FY 1998 Financial Statements (Report No. 99-209)

We are providing this report for review and comments. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense (Comptroller) comments were not responsive to Recommendation 1., and the Defense Finance and Accounting Service comments were not responsive to Recommendation 3. Therefore, we request that the Under Secretary of Defense (Comptroller) and Defense Finance and Accounting Service provide comments on these recommendations by August 9, 1999.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David F. Vincent at (703) 604-9110 (DSN 664-9110) (dvincent@dodig.osd.mil) or Mr. Thomas J. Winter at (703) 604-9134 (DSN 664-9134) (twinter@dodig.osd.mil). See Appendix D 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. 99-209
(Project No. 9FH-2003)

July 9, 1999

Data Supporting the DoD Environmental Line Item Liability on the FY 1998 Financial Statements

Executive Summary

Introduction. We performed this audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires DoD and other Government agencies to prepare consolidated financial statements. This audit supports our audit of the FY 1998 DoD Agency-wide financial statements and future audits of financial statements that are required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. The Balance Sheet is part of the DoD Agency-wide financial statements and includes a line item for environmental liabilities. Environmental liabilities include estimated amounts for future cleanup of environmental pollution at past and present DoD sites. The FY 1998 Balance Sheet reported an environmental line item liability of \$34.2 billion for future cleanup of 12,761 sites at 3,258 present and former installations.

Objectives. The audit objective was to evaluate the reliability and completeness of the data used to calculate the DoD environmental liability for FY 1998. We also reviewed the adequacy of the internal control program as it applied to the audit objective.

Results. The data supporting the environmental line item liability in the Balance Sheet were not reliable or complete. DoD had not provided criteria for reporting environmental liabilities; the data were not adequately supported; the computer model used to prepare cleanup cost estimates was materially inaccurate; and the reported liability did not include amounts for weapon system disposal, overseas environmental liabilities, or disposal of unexploded ordnance and ammunition. Additionally, proposed guidance on environmental liabilities in DoD Regulation 7000.14-R, the "DoD Financial Management Regulation," includes questionable guidance on recognition of dollar amounts and the timing of environmental and disposal liabilities. See the Finding for details of the audit results. We also identified material internal control weaknesses, as discussed in Appendix A. The recommendations in this report, if implemented, will enhance the reliability and completeness of the environmental line item liability in the Balance Sheet, which is part of the DoD Agency-wide financial statements.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) amend DoD Regulation 7000.14-R to require that environmental and disposal liabilities include amounts for weapon system disposal, overseas environmental cleanup, and disposal of unexploded ordnance and ammunition. We also recommend that the Deputy Under Secretary of Defense (Environmental Security) require DoD installations to use approved methodologies to prepare environmental cleanup cost estimates, and to document the original estimates and any subsequent changes. We also

recommend that the Defense Finance and Accounting Service report material weaknesses related to reporting environmental liabilities in its Annual Statement of Assurance.

Management Comments. The Under Secretary of Defense (Comptroller) did not concur with the recommendation, stating that DoD Regulation 7000.14-R already includes guidance on environmental and disposal liabilities. The Under Secretary of Defense (Comptroller) further stated that the draft chapters of the Regulation are consistent with Federal accounting standards and generally accepted accounting principles.

The Deputy Under Secretary of Defense (Environmental Security) agreed to publish guidance on environmental cleanup cost estimates. The Defense Finance and Accounting Service comments stated that the USD(C), Office of the Deputy Chief Financial Officer, Directorate for Management Improvement, prepares the DoD Annual Statement of Assurance and is responsible for issuing guidance on correcting material weaknesses. See the Finding for a discussion of management comments and the Management Comments section for the text of the comments.

Audit Response. The Under Secretary of Defense (Comptroller) comments are not responsive. The Under Secretary of Defense (Comptroller) recognized the need for additional guidance and prepared two draft chapters of DoD Regulation 7000.14-R to provide guidance on environmental and disposal liabilities. In January 1999, we provided written comments on the draft chapters and recommended specific modifications to make DoD Regulation 7000.14-R consistent with Federal accounting standards. However, the draft chapters still do not properly account for all aspects of the environmental liability in the DoD financial statements. As a result, we continue to recommend that the Under Secretary of Defense (Comptroller) amend DoD Regulation 7000.14-R to make the regulation consistent with Federal accounting standards and generally accepted accounting principles.

The comments and corrective action by the Deputy Under Secretary of Defense (Environmental Security) are responsive. However, the Defense Finance and Accounting Service comments are not responsive. An agency with material internal control weaknesses is responsible for identifying, reporting, and correcting the weaknesses. The Deputy Chief Financial Officer is not responsible for detecting and correcting material weaknesses in another agency, and cannot be aware of the weaknesses unless they are reported by other agencies. Therefore, the Defense Finance and Accounting Service must provide notice of this weakness and take corrective action. We request that the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, provide additional comments on the final report by August 9, 1999.

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Background

Reporting Requirements. Public Law 101-576, the “Chief Financial Officers [CFO] Act of 1990,” November 15, 1990, requires Federal organizations to prepare annual audited financial statements. The CFO Act also requires the Inspectors General to audit all financial statements prepared under the CFO Act. The CFO Act, as amended by Public Law 103-356, the “Federal Financial Management Act of 1994,” October 13, 1994, requires DoD and other Government agencies to prepare agency-wide financial statements for FY 1996 and the following years.

Environmental Cleanup Statutory Requirements. Public Law 96-510, the “Comprehensive Environmental Response, Compensation, and Liability Act” (CERCLA), as amended by Public Law 99-499, established a comprehensive framework to identify, investigate, and clean up releases of hazardous materials. CERCLA provides the statutory authority for cleanup of hazardous materials that could endanger public health, public welfare, or the environment. The “Resource Conservation and Recovery Act of 1976,” title 42, United States Code, created a comprehensive Federal regulatory program for hazardous waste control.

DoD Implementation of CERCLA. The Deputy Under Secretary of Defense (Environmental Security) is responsible for environmental cleanup within DoD. The DoD Office of Environmental Cleanup, as part of the Office of the Deputy Under Secretary of Defense (Environmental Security), manages the Defense Environmental Restoration Program. The Army, Navy, Air Force, and Defense Logistics Agency execute the cleanup work at 3,258 present and former installations nationwide, at a cost of about \$2 billion annually.

Liability for Environmental Cleanup. DoD reports the liability for environmental cleanup in its financial statements. The FY 1998 DoD Agency-wide financial statements reported an environmental liability of \$34.2 billion, representing the estimated cleanup cost for future years.

Objectives

The objective was to evaluate the reliability and completeness of the data used to calculate the DoD environmental liability for FY 1998. We also reviewed the adequacy of the internal control program as it applied to the stated objective. The review of the management control program is discussed in Appendix A. Appendix B lists prior audit reports on environmental and disposal liabilities.

Data Supporting the FY 1998 Environmental Liability

The data supporting the \$34.2 billion environmental liability reported for FY 1998 were not accurate, complete, or supportable. This occurred because DoD had not provided criteria for reporting environmental liabilities, the cleanup cost estimation process was not adequately documented, consistent cost estimating procedures were not used, and significant liabilities for weapon system disposal and overseas cleanup were not included in the reported liability balance. As a result, the environmental line item liability in the Balance Sheet was unreliable and likely to be materially understated.

Reporting Criteria for Environmental Liabilities

Current Guidance. DoD did not issue guidance specific for accounting and reporting of environmental liabilities in the FY 1998 financial statements. Statement of Federal Financial Accounting Standards (SFFAS) No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995, provides for recognition of liabilities, including those arising from past environmental events, where the future outflow of resources is probable and measurable. Probable means the liability is more likely than not to occur. Measurable means the amount can be reasonably estimated and expressed in dollars. DoD Regulation 7000.14-R, volume 4, chapter 13, January 1995, provides guidance consistent with SFFAS No. 5 for DoD but does not specifically mention environmental liabilities. SFFAS No. 6, "Accounting for Property, Plant, and Equipment," November 30, 1995, provides accounting guidance for environmental cleanup and disposal liabilities related to property, plant, and equipment. DoD Regulation 7000.14-R, which was used to prepare the FY 1998 financial statements, did not discuss those issues. Current guidance also did not discuss cleanup of training ranges and ammunition.

Draft Chapters of DoD Regulation 7000.14-R. In December 1998, the Office of the Under Secretary of Defense (Comptroller) (USD[C]) released two draft chapters of DoD Regulation 7000.14-R for comments. The draft chapters discuss accounting issues for disposal and environmental liabilities. The USD(C) set a deadline of January 15, 1999, for comments on the draft. See Appendix C for a discussion of the draft chapters.

Documentation

Cost-to-complete (CTC) estimates form the basis of the environmental line item liability reported in the Balance Sheet. However, about half of the estimates were not adequately documented, and the audit trail from estimates to the Balance Sheet was inadequate.

Requirements for Audit Trails. DoD Regulation 7000.14-R, in Key Accounting Requirement No. 8, "Audit Trails," states that accounting systems must have audit trails that allow transactions to be traced from initiation through processing to final reports. A fundamental requirement of a good audit trail is that transactions, including CTC estimates that support the environmental liability line item, must be adequately supported with pertinent documents and source records. Also, DoD Regulation 7000.14-R, volume 4, chapter 8, "Financial Control of Liabilities," January 1995, states that amounts recorded as liabilities shall be supported by sufficient documentation to establish the basis for the claim against DoD.

Army. Audit trails were inadequate and oversight was inconsistent at Army environmental activities. The Army Audit Agency, in 24 audit reports on the Army financial statements for FYs 1996 and 1997, could not attest to the accuracy and completeness of the reported liabilities. Army Audit Agency reports for FY 1998 stated that cleanup estimates totaling \$23 billion were unsupported.

Navy. Navy activities with environmental cleanup sites did not maintain adequate support for CTC estimates. The Naval Audit Service reported that about half of the audit sample estimates were not documented. Estimates were not documented because the engineers who prepared the estimates were not required to maintain documentation and the supporting rationale. As a result, the Naval Audit Service could not determine whether \$5.8 billion of CTC estimates for site cleanup were reasonable.

Air Force. The Air Force Audit Agency determined that Air Force installations could not fully support \$5.6 billion in CTC estimates. The Air Force Audit Agency reviewed documentation for 12 installations with cleanup sites for which CTC estimates totaled \$468 million. Estimates at 2 of the 12 installations were fully documented, estimates at 7 installations were partially documented, and estimates at 3 installations were undocumented. In most cases, estimates were undocumented or partially documented because civil engineers did not retain documentation of estimates to support the financial statements, and local guidance did not require them to do so. Some civil engineers were unaware of the need for documentation. However, DoD Regulation 7000.14-R, volume 4, chapter 8, states that amounts recorded as liabilities shall be supported by sufficient documentation.

An audit trail sufficient to trace a liability from source documentation to the financial statements is needed to test the validity of reported environmental

liabilities through transaction testing. The source documentation should include a narrative providing sufficient explanation for the basis of the estimate, the date prepared, the preparer's name, and evidence of supervisory approval. Original estimates and changes in those estimates should be documented and available for review. The Military Departments need to create an adequate audit trail of cleanup cost estimates and subsequent changes.

Environmental Cleanup Cost Estimates

The Military Departments used different computerized models to compute CTC estimates. Existing Navy and Air Force models usually overestimated costs by about 20 percent on average, but some estimates for individual sites were inaccurate by 100 percent or more. Additionally, the estimates were subject to engineering decisions about what was needed to clean up a site and were also subject to the information developed in site assessments. Further, the models were not centrally managed by DoD to ensure a standard among the Military Departments. As a result, different models could generate different estimates based on identical data.

Use of Computer Models. The computer models were based on unit costs for the various cleanup technologies. Independent contractors and the U.S. Army Corps of Engineers developed the unit cost data. Civil engineers determined, based on known information about a site, the type and extent of cleanup methods required. The computer models calculated the CTC estimate based on this input. However, some engineers considered the estimates generated by the models to be highly subjective and inaccurate, and therefore modified the output based on their judgment.

Engineering Judgment. Determinations of the technologies to be used, and the extent to which each technology is to be used, are subject to professional engineering judgment and differences in professional opinion. These determinations can significantly affect the CTC estimate.

Extent of Site Contamination. The initial site assessments may not fully assess the scope of the contamination, either in type of contaminants or the extent of the contamination. The migration of contamination from the original site can be significant and can be determined only through detailed ground and groundwater testing.

Contractor Bidding. CTC estimates were, by their nature, only estimates. The actual costs can be determined only when contractors submit bids and the cleanup begins.

Evolving Technology. Environmental cleanup is an evolving technology, with new methods being developed constantly. As a result, an estimate may need to be revised because more efficient and less costly technologies may become available before the cleanup begins.

Cost-to-Complete Estimates. The Navy used the CTC program to generate computerized estimates of the cost to complete environmental cleanup at specific sites. Environmental engineers determined the type and scope of cleanup activity. The type and scope of cleanup activity was selected from menus in the program. The program computed the estimates using previously developed unit cost data. However, the CTC estimates generated in this manner may have been materially inaccurate. The computer models used by the other Military Departments were variants of the Navy model.

A preliminary Navy study indicated that the version of CTC in use generated estimates that were overstated, based on historical cost data, by an average of almost 20 percent. The specifications for the model permitted estimates ranging from 30 percent under to 50 percent over, which was far beyond the generally accepted materiality threshold. Estimates for certain sites may have been inaccurate by more than 100 percent. As a result, the total estimated environmental liability for the Navy may have been materially inaccurate.

Reliable Model. Because the computerized models used to estimate cleanup costs were unreliable, they were not regularly used by civil engineers at Air Force installations. Engineers at the Air Force installations considered the estimates from the models to be educated guesses because the sites might be cleaned up in a manner different than anticipated by the computerized model. Before contractors bid on a project, the estimates were subjective. Further, site cleanup technology changed constantly, and the model may not always have reflected the best technology. In addition, the extent and migration of site contamination could be known only after site testing. The Remedial Action Cost Engineering and Requirements model, a variant of the Navy model, overestimated cleanup costs by an average of about 20 percent. However, the estimating error for a given site could be as high as 100 percent. Although the results could be modified by adjusting the input, civil engineers stated that this procedure was tedious. As a result, many civil engineers based their cost estimates on engineering studies instead of relying on the model. The Military Departments need a model for cost estimates that more accurately predicts cleanup costs and is approved by DoD.

Liabilities for Weapon System Disposal

The reported liability amount did not include environmental and disposal liabilities associated with weapon system disposal. Because of the substantial number of weapon systems in existence, environmental liabilities associated with their eventual disposal are likely to be material.

Army. DoD is required to destroy the weapon systems in its chemical munitions stockpile by April 29, 2007, in accordance with Public Law 99-145, subsequent amendments, and the Chemical Weapons Convention. The Army, as the executive agent for DoD, manages the Chemical Demilitarization Program. For FY 1997, the reportable liability was about \$10.5 billion. However, the amount was incorrectly classified as Other Liabilities. The Army financial statements for FY 1998 included \$10.6 billion for chemical demilitarization in the reported environmental liability. The reported liability did not include any amounts for disposal of unexploded ordnance or ammunition, or for cleanup of closed ranges.

Navy. The Navy portion of the DoD environmental liability balance did not include amounts for the future disposal of nuclear reactors and related radioactive waste. The Navy has 95 nuclear-powered ships, all of which will eventually be taken out of service and their nuclear components disposed. Estimates of the disposal cost for each ship were \$19 to \$100 million for submarines and at least \$500 million for aircraft carriers. This omission occurred because of a lack of guidance specifically requiring that such disposal liabilities be reported. Also, there was no program similar to the Defense Environmental Restoration Program to track such liabilities. As a result, we estimated that environmental and disposal liabilities of at least \$6.7 billion to \$13.2 billion were omitted from the environmental line item liability in the DoD Agency-wide financial statements.

Air Force. Air Force managers did not establish a requirement for reporting liabilities for weapon system disposal. The Air Force eventually disposes of weapon systems and can estimate the disposal cost when new systems are placed in service. When the Air Force decommissions weapon systems, it may have environmental liabilities related to fuel and lubricants, fire suppressant, batteries, composites, and coolants. To more accurately account for its environmental liabilities, the Air Force needs to estimate and report liabilities related to weapon system disposal.

Environmental Liabilities Overseas

DoD did not disclose liabilities for overseas environmental cleanup. DoD presence in other countries has resulted in environmental damage that will require eventual cleanup and disposal, and the cleanup costs will be substantial.

Subject to Treaty and Negotiation. For its past and present operations in other nations, DoD is not subject to the CERCLA and other environmental cleanup requirements that apply to sites in the U.S. As a result, the DoD environmental liability for overseas sites is determined on a case-by-case basis by treaty and negotiations.

Germany. The U.S. has maintained a large military presence in Germany since the end of World War II and has created substantial requirements for environmental cleanup. The estimated cost to clean up known sites for which the U.S. is responsible, based on claims filed by German authorities, is about \$1 billion.

Panama. The U.S. has operated military bases in Panama for almost 100 years. These military bases include jungle test sites for munitions that include chemical agents. The resulting environmental damage requires cleanup and restoration that the U.S. is liable for under treaty provisions to the extent practicable and measurable. The cleanup cost for sites in Panama has not been estimated, but is likely to be substantial.

Other. DoD may have unreported environmental liabilities in other nations in which it has military bases. Potentially significant liabilities may exist in Japan, South Korea, the Philippines, Turkey, Great Britain, Spain, Canada, and other nations. DoD should review existing treaties, Status of Forces agreements, and other agreements to determine whether environmental liabilities exist. If a liability does exist, an estimate for the associated cleanup costs should be prepared. DoD should also disclose amounts claimed under treaty by host nations and amounts agreed to in negotiations.

Conclusion

The FY 1998 amount reported for environmental liability in the Balance Sheet was not accurately stated, was materially incomplete, and the underlying data were unsupported. The reported environmental liability was inaccurate, incomplete, and unsupported because of an absence of guidance on accounting for and reporting environmental and disposal liabilities. Also, DoD had not implemented a comprehensive and reasonable set of procedures designed to ensure reasonably accurate estimates of environmental cleanup costs, to report all environmental and disposal-related liabilities, and to create an audit trail for the entire process. As a result, the reported environmental liability was unreliable and unauditible. Until the deficiencies discussed in this report are corrected, the unreliability of the environmental liability line item will prevent a favorable audit opinion on the DoD Agency-wide financial statements.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Under Secretary of Defense (Comptroller) amend DoD Regulation 7000.14-R to require that environmental and disposal liabilities include amounts for weapon systems disposal, overseas environmental cleanup, and disposal of unexploded ordnance and ammunition.

Management Comments. The USD(C) stated that he had prepared, and circulated for comments, two draft chapters of DoD Regulation 7000.14-R, intended to establish specific guidance for reporting environmental and disposal liabilities. The USD(C) also stated that DoD Regulation 7000.14-R already included guidance for reporting environmental liabilities in volume 6B, chapter 4, "Balance Sheet." Further, the USD(C) stated that the draft chapters of DoD Regulation 7000.14-R are consistent with Federal accounting standards and generally accepted accounting principles. In addition, the USD(C) stated that the concerns of the Inspector General, DoD, about the timing of liability recognition appeared to result from differing views on when a nonenvironmental disposal liability comes into being. The USD(C) stated that recognition of the liability should occur when management decides to dispose of the asset, not when it is acquired.

The USD(C) stated there is a distinction between environmental cleanup responsibilities in the U.S. and overseas. The USD(C) agreed to review the extent and magnitude of overseas cleanup liabilities with the Deputy Under Secretary of Defense (Environmental Security) and, if warranted, revise the Financial Management Regulation guidance on restoration activities overseas. The USD(C) explained that overseas restoration activities are subject to the availability of funds, legal determinations on responsibilities, offsets for DoD-funded improvements and host nation or third party contributions.

Audit Response. The USD(C) comments did not adequately address the recommendation. The existing DoD Regulation 7000.14-R did not include specific guidance on reporting requirements or when environmental and disposal liabilities should be recognized and, as a result, the USD(C) prepared two draft chapters of DoD Regulation 7000.14-R. In January 1999, we provided written comments on the draft chapters and recommended specific modifications to make DoD Regulation 7000.14-R consistent with SFFAS No. 5 and generally accepted accounting principles.

We continue to recommend that the USD(C) make changes to the draft chapters because the updated regulation is inconsistent with SFFAS No. 5 and generally accepted accounting principles. SFFAS No. 5 and generally accepted accounting principles clearly state the requirements for recognition of liabilities,

including timing. Recognition of a liability occurs when it is probable and estimable, and can be done when the asset is acquired. Therefore, waiting for a management decision for disposal does not apply for recognition purposes. There are no exceptions to the general rules for environmental, disposal, or other types of liabilities. The USD(C) comments do not indicate agreement with the recommended modifications. If the recommended modifications are not made, the result could be a material misstatement of the environmental liability in the Balance Sheet. The coordinated effort with the Deputy Under Secretary of Defense (Environmental Security) on environmental restoration is a positive action. However, we request that the USD(C) reconsider its position on the recommendation in response to the final report.

2. We recommend that the Deputy Under Secretary of Defense (Environmental Security) implement guidance requiring:

a. DoD installations to use computer models that are verified, validated, and accredited at the DoD level to generate cost-to-complete estimates, and to use the estimates to support the installations' total environmental liability.

b. Documentation of the cost-to-complete estimates and any subsequent changes.

Management Comments. The Deputy Under Secretary of Defense (Environmental Security) concurred with the recommendation and agreed to take corrective action.

3. We recommend that the Director, Defense Finance and Accounting Service, report material weaknesses related to the reporting of environmental liabilities in the Annual Statement of Assurance, including:

a. Lack of supporting documentation and audit trails.

b. Incomplete reporting of environmental and disposal liabilities because of the exclusion of amounts for weapon systems disposal and overseas environmental cleanup.

Management Comments. The Defense Finance and Accounting Service comments state that the USD(C), Office of the Deputy Chief Financial Officer, Directorate for Management Improvement, is responsible for preparing the DoD Annual Statement of Assurance and for issuing guidance and correcting material weaknesses. The Defense Finance and Accounting Service suggested that the recommendation be redirected to the Directorate for Management Improvement.

Audit Response. The Defense Finance and Accounting Service comments do not address the issues. The Defense Finance and Accounting Service should report material weaknesses because that organization is responsible for implementing appropriate corrective action. The Directorate for Management

Improvement cannot include another agency's material weaknesses in the DoD Annual Statement of Assurance or issue any related guidance unless the Defense Finance and Accounting Service reports the weaknesses in its own Annual Statement of Assurance. We request that the Director, Defense Finance and Accounting Service, reconsider his position on the recommendation and provide comments on the final report.

Appendix A. Audit Process

Scope and Methodology

Scope. We reviewed the data supporting the \$34.2 billion environmental liability line item reported in the DoD FY 1998 Balance Sheet. Specifically, we:

- evaluated guidance from the Financial Accounting Standards Advisory Board and in DoD Regulation 7000.14-R on reporting environmental and disposal liabilities, including draft chapters of DoD Regulation 7000.14-R that were circulated for comment in December 1998;
- identified DoD activities worldwide that give rise to environmental liabilities and determined whether such activities were included in the liability reported in the DoD FY 1998 Agency-wide Balance Sheet;
- reviewed and directed the work of Army Audit Agency, Naval Audit Service, and Air Force Audit Agency auditors on the environmental liability line items of the Military Departments' financial statements; and
- determined the degree to which the reported environmental liability balance was supportable.

Limitation to Scope. We did not test the accuracy of the environmental restoration cost estimates because many of the estimates were undocumented, and therefore could not be reviewed for accuracy with respect to historical data from other cleanup efforts. This limitation in scope did not materially affect the audit results.

Use of Computer-Processed Data. We did not use computer-processed data to support the audit conclusions.

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 achievement of the following objective and goal.

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 functional area objective and goal.

Financial Management Objective: Strengthen internal controls.
Goal: Improve compliance with the Federal Managers' Financial Integrity Act. (FM-5.3)

General Accounting Office High-Risk Area. The General Accounting Office has 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. We performed this financial-related audit from October 1998 through February 1999 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, subject to the limitations in scope described in this appendix. Accordingly, we included tests of internal controls considered necessary.

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

Management Control Program

DoD Directive 5010.38, "Management Control (MC) Program," and DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996, require DoD managers to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of those controls.

Scope of Review of the Management Control Program. Auditors from the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency reviewed the environmental liability line items on the Military Departments' financial statements, including reviews of management controls. The auditors reviewed the controls in place for accounting and reporting of environmental cleanup costs and the associated environmental liability line item in the Balance Sheet.

Adequacy of Management Controls. We identified material management control weaknesses, as defined by DoD Directive 5010.38. DoD-level guidance on accounting for environmental liabilities was lacking, policy and procedures were not in place to ensure that cost estimates and changes were adequately documented, environmental engineers overrode the results of computerized cleanup cost estimates, and computer models were inaccurate. The recommendations in this report, if implemented, will improve the accuracy and

reliability of the DoD environmental liability line item in the Balance Sheet in future years. A copy of this report will be provided to the senior officials responsible for management controls in the Offices of the USD(C) and the Deputy Under Secretary of Defense (Environmental Security) and in DFAS.

Adequacy of Management's Self-Evaluation. Management's self-evaluation did not identify the material management control weaknesses because environmental liabilities were not a separate assessable unit or included in an existing assessable unit.

Appendix B. Summary of Prior Coverage

The General Accounting Office; the Inspector General, DoD; the Army Audit Agency; the Naval Audit Service; and the Air Force Audit Agency have issued 33 reports on environmental and disposal liabilities in the last 5 years.

General Accounting Office

Report No. GAO/NSIAD-98-127 (OSD Case No. 1623), "1997 Consolidated Financial Statements of the United States Government," March 31, 1998.

Report No. GAO/AIMD-98-32 (OSD Case No. 1491), "DoD's Liability for the Disposal of Conventional Ammunition Can Be Estimated," December 19, 1997.

Report No. GAO/AIMD-98-9 (OSD Case No. 1476), "DoD's Liability for Aircraft Disposal Can Be Estimated," November 20, 1997.

Report No. GAO/AIMD-97-135R (OSD Case No. 1408), "Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships," August 7, 1997.

Report No. GAO/NSIAD-97-135 (OSD Case No. 1331), "Information Used for Defense Environmental Management," June 11, 1997.

Inspector General, DoD

Inspector General, DoD, Report No. 98-170, "Army National Guard and U.S. Army Reserve Command Small Arms Indoor Firing Ranges," June 30, 1998.

Inspector General, DoD, Report No. 98-161, "Internal Controls and Compliance with Laws and Regulations for the DoD Agency-wide Financial Statements for FY 1997," June 22, 1998.

Inspector General, DoD, Report No. 98-021, "Management of Underground Storage Tanks at Defense Logistics Agency Centers," November 13, 1997.

Army Audit Agency

The Army Audit Agency issued 24 individual installation audit reports during FY 1998 that discussed the deficiencies of CTC estimates throughout the Army command structure. Fifteen of these individual installation reports were memorandum reports that will be consolidated into a single report on execution of environmental projects for FY 1998, which will be issued in July 1999.

Air Force Audit Agency

Air Force Audit Agency Report, Project No. 97053005, "Accounting for Air Force Liabilities, Fiscal Year 1997 Air Force Consolidated Financial Statements," November 4, 1998.

Appendix C. Financial Regulations on Environmental Restoration

In December 1998, the USD(C) released two draft chapters of DoD Regulation 7000.14-R for comments. The chapters are intended to become volume 4, chapter 13, "Accrued Disposal Cost," and volume 4, chapter 14, "Accrued Environmental Restoration (Cleanup)." The draft chapters include guidance inconsistent with generally accepted accounting principles for liability recognition and reporting. We provided written comments to the USD(C), stating our concerns and recommending changes, in January 1999.

The draft chapters state, in agreement with SFFAS No. 6, that specified categories of disposal and environmental liabilities should be recognized incrementally over more than one fiscal year. However, this provision is inconsistent with the general rule for liability recognition stated in SFFAS No. 5. Further, in cases where there is a range of estimates in which no single value is the most reliable, the draft chapters state that only the lowest value is to be used. Generally accepted accounting principles for liabilities, as stated in SFFAS No. 5, require recognition of the full amount of the liability in the year in which a future payment is probable and measurable. This requirement is without regard to the type of liability or when future payment will occur. SFFAS No. 5 also states that when there is a range of values and no single value is the most reliable, the lower value should be reported but the full range disclosed.

The draft chapters are in response to the recognized need to provide guidance that is specific to reporting disposal and environmental liabilities. However, guidance that is inconsistent with generally accepted accounting principles does not properly serve either the DoD accounting community or the users of the financial statements because it could result in material misstatements in the reported liability. Our comments on the draft chapters requested that the USD(C) incorporate the suggested changes in the draft chapters before including the chapters in DoD Regulation 7000.14-R. If the draft guidance is not amended to be consistent with generally accepted accounting principles, the inconsistencies will constitute a material obstacle in the progress toward an unqualified opinion on the DoD Agency-wide financial statements.

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
Deputy Under Secretary of Defense (Environmental Security)
Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Director, Accounting Policy
Deputy Comptroller (Program/Budget)

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 Finance and Accounting Service
Director, Defense Finance and Accounting Service Indianapolis Center

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
National Security and International Affairs Division
Technical Information Center

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

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 Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International
Relations, Committee on Government Reform

Under Secretary of Defense (Comptroller) Comments



COMPTROLLER

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAY 7 1999



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

SUBJECT: Draft Audit Report, "Data Supporting the DoD Environmental Line Item Liability
on the FY 1998 Financial Statements" (Project No. 9FH-2003)

This is in response to Recommendation 1 of the subject draft audit report. Specifically, the recommendation proposes that the Under Secretary of Defense (Comptroller) amend the "DoD Financial Management Regulation" ("DoDFMR") to require that environmental and disposal liabilities include amounts for weapons systems disposal and overseas environmental cleanup.

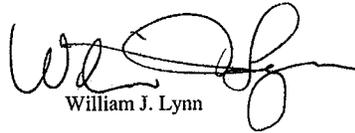
On October 6, 1998, the Department provided the Office of Management and Budget and the General Accounting Office, as well as your office, the Department's proposed implementation strategies for addressing the issues regarding policies and guidance for estimating environmental restoration, hazardous waste, and nonenvironmental disposal liabilities. To date, this office has drafted and sent to coordination proposed chapters to the "DoDFMR" that establish required policies and guidance on estimating and reporting environmental and nonenvironmental disposal of property, plant, and equipment. Once required coordinations are received, this office intends to publish the applicable guidance.

The subject draft audit report questions the proposed guidance regarding when nonenvironmental disposal liabilities should be recognized and reported. Specifically, the draft report asserts that the proposed guidance is not consistent with generally accepted accounting principles that apply to the recognition and reporting of liabilities and, therefore, could present a material obstacle to the Department's progress toward a clean audit opinion. The comments in the draft report apparently appear to result from differing views as to what event triggers a nonenvironmental disposal liability. This office believes that the content of the draft guidance is consistent with federal accounting standards and generally accepted accounting principles.

Also, this office does not agree with the assertion that the Department did not issue guidance for reporting environmental liabilities in the FY 1998 financial statements. To the contrary, Chapter 4, "Balance Sheet," of Volume 6B, of the DoD Financial Management Regulation includes such guidance.

Additional comments are provided in the attachment.

This office appreciates the opportunity to comment on the draft report. My point of contact for this matter is Mr. Chuck Crichley. He may be reached by e-mail: crichlec@osd.pentagon.mil or by telephone at (703) 693-6505.



William J. Lynn

Attachment

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)

Draft Report, "Audit Report on the Data Supporting the DoD Environmental Line Item Liability on the FY 1998 Financial Statements" (Project No. 9FH-2003)

GENERAL COMMENTS

Page (i), Executive Summary, et al: The draft report incorrectly asserts that the Department of Defense (DoD) did not issue guidance for reporting environmental liabilities in the FY 1998 financial statements. To the contrary, Chapter 4, "Balance Sheet," Volume 6B of the DoD Financial Management Regulation ("DoDFMR") does include guidance on this subject. Paragraph 040206.F, for example, discusses requirements in the Statements of Federal Financial Accounting Standards (SFFAS) (SFFAS No. 5, "Accounting for Liabilities of the Federal Government" and SFFAS No. 6, "Accounting for Property, Plant, and Equipment") and their applicability to general and stewardship assets. Guidance on footnote disclosure is provided in Chapter 10, "Notes to Financial Statements," Volume 6B of the "DoDFMR."

Page (i), Executive Summary, et al: The draft report asserts that the guidance proposed for the "DoDFMR" includes questionable guidance on the timing of environmental and disposal liability recognition. Further, it asserts that the guidance proposed for Chapters 13 and 14 of the "DoDFMR" is not consistent with the generally accepted accounting principles that apply to liability recognition and reporting and could present a material obstacle to the DoD's progress toward a clean audit opinion.

The comments appear to result from differing views as to what event triggers a disposal liability. This office believes that the proposed "DoDFMR" guidance is consistent with the environmental cleanup requirements in SFFAS No. 6 and the general liability standards in SFFAS No. 5. Nonenvironmental disposal plans and activities are the result of prudent business decisions and are largely discretionary in scope and timing as asset capabilities, capacities, and useful lives continuously are adjusted to meet current needs (e.g., renovations, modifications, service life extension programs, etc.). Accordingly, this office does not believe that a nonenvironmental disposal obligation automatically is triggered on the date that an asset is acquired. Similarly, the temporary idling of an asset does not necessarily create a nonenvironmental disposal obligation. It is only when management makes a formal decision to dispose of an asset that an obligation for a nonenvironmental disposal liability is created and needs to be recognized for financial reporting. Recognition of future nonenvironmental disposal cost estimates as financial obligations at the time of asset placement in service is not a requirement of SFFAS No. 5.

RECOMMENDATION

RECOMMENDATION 1: The draft report recommends that the Under Secretary of Defense (Comptroller) (USD(C)) amend the "DoDFMR" to require that environmental and disposal liabilities include amounts for weapons systems disposal and overseas environmental cleanup.

OUSD(C) RESPONSE: This office drafted accounting policy guidance that addresses the environmental and nonenvironmental disposal of National Defense property, plant, and equipment. The draft policy was distributed for formal coordination on December 3, 1998. Upon the receipt of required coordinations and the incorporation of any changes considered necessary to address comments received in the formal coordination process, the policy guidance will be published in the "DoDFMR."

There is a distinction between environmental cleanup responsibilities in the United States and the determination and conduct of remediation to correct environmental problems outside the United States. The responsibilities and procedures are different in several respects, as discussed in DoD Instruction 4715.8, "Environmental Remediation for DoD Activities Overseas." Above all, obligations for overseas cleanup activities are subject to the availability of funds. Legal determinations on responsibility may be required, and offsets for DoD funded improvements and/or host-nation or third party contributions may be involved. SFFAS No. 5 states that a government acknowledged event should only be recognized as a liability when the Congress authorizes the required funding and amounts due are unpaid at the reporting date. Under these conditions, it is unlikely that a material obligation would exist at the end of a fiscal year. The OUSD(C) will review the extent and magnitude of such activities with the Office of the Deputy Under Secretary of Defense (Environmental Security). If warranted, the "DoDFMR" will be revised to include additional revised guidance on restoration activities overseas.

Deputy Under Secretary of Defense (Environmental Security) Comments



ACQUISITION AND
TECHNOLOGY

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

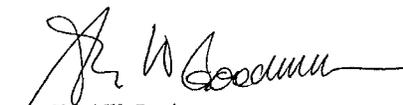
APR 23 1999

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

SUBJECT: Deputy Under Secretary of Defense (Environmental Security) response to
Office of the Inspector General, Department of Defense Draft Report, "Audit
Report on the Data Supporting the DoD Environmental Line Item Liability on the
FY 1998 Financial Statements (Project No 9FH-2003),"
Dated March 17, 1999

The draft report recommends that the Deputy Under Secretary of Defense (Environmental Security) implement guidance on the use of cost-to-complete cleanup computer models and the documentation of the cost-to-complete estimates, to make the environmental liability reported in the DoD Financial Statement more accurate and complete.

I concur with the recommendations and will direct ODUSD(ES) Cleanup to publish the guidance and implement these specific recommendations.



Sherri W Goodman
Deputy Under Secretary of Defense
(Environmental Security)

Environmental Security



Defending Our Future

Defense Finance and Accounting Service Comments



DFAS-HQ/ASF

DEFENSE FINANCE AND ACCOUNTING SERVICE

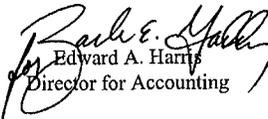
1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291

APR 15 1999

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

SUBJECT: Audit Report on the Data Supporting the DoD Environmental Line Item Liability on
the FY 1998 Financial Statements (Project No. 9FH-2003)

Our response to the subject audit is attached. The primary point of contact (POC) is
Mr. Wayne Ebaugh, (703) 607-2857 or DSN 327-2857, and the secondary POC is
Mr. Mike Bryant, (703) 607-1562 or DSN 327-1562.


Edward A. Harris
Director for Accounting

Attachment:
As stated

cc:
DFAS-HQ/PO
DFAS-IN/P

**DFAS Comments on Audit Report on the Data Supporting the DOD Environmental Line
Item Liability on the FY 1998 Financial Statements (Project No. 9FH-2003)**

Responses to Recommendations

Recommendation 3: We recommend that the Director, Defense Finance and Accounting Service, report material weaknesses related to the reporting of environmental liabilities in the Annual Statement of Assurance, including:

- a. Lack of supporting documentation and audit trails, and
- b. Incomplete reporting of environmental and disposal liabilities because of exclusion of amounts for weapons systems disposal and overseas environmental cleanup.

DFAS Management Comments: Each year, the DoD Annual Statement of Assurance is prepared by the Office of the Under Secretary of Defense (Comptroller), Office of the Deputy Chief Financial Officer, Directorate for Management Improvement. The Directorate for Management Improvement is responsible for issuing guidance for correcting material weaknesses. We suggest that this recommendation be forwarded to OUSD(C) MI for action.

Audit Team Members

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

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