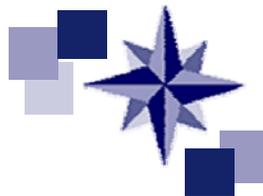


**Department of Defense
Office of the Inspector General**



**Financial Statement Audit
Fiscal Year 2006**

Submitted by



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Table of Contents

Management Discussion and Analysis	1
I. Background.....	1
II. Vision Statement.....	1
III. Mission Statement.....	1
IV. Core Values.....	1
V. Organization.....	1
VI. Budgetary and Financial Aspects	4
VII. Systems, Controls, and Legal Compliance	5
VIII. Performance Information	6
IX. Results.....	7
X. Events, Trends, and Risks.....	11
Independent Auditors' Report	13
Financial Statements.....	18
Notes to the Basic Statements	25
Appendix A – DoD OIG Management’s Comments On the Auditors’ Report	43

Management Discussion and Analysis

I. Background

The Inspector General Act of 1978 established civilian Offices of Inspectors General in six cabinet-level federal departments and in an additional six federal agencies. Although Inspectors General have been a part of the armed forces since the Revolutionary War, the Department of Defense Office of Inspector General (DoD OIG), was not established until much later when Congress amended the Inspector General Act in the National Defense Authorization Act for Fiscal Year 1983 (P.L. 97-252, enacted on September 8, 1982).

Pursuant to the Inspector General Act of 1978, as amended, "the Inspector General of the Department of Defense shall . . . be the principal adviser to the Secretary of Defense for matters relating to the prevention of fraud, waste, and abuse in the programs and operations of the Department."

The law also requires the Inspector General "to keep the [Secretary of Defense] and the Congress fully and currently informed . . . concerning fraud and other serious problems, abuses, and deficiencies . . ." In carrying out all of the other statutory duties, the Inspector General of the Department of Defense is obligated by law to "give particular regard to the activities of the internal audit, inspection, and investigative units of the military departments with a view towards avoiding duplication and insuring effective coordination and cooperation."

II. Vision Statement

One professional team strengthening the integrity, efficiency, and effectiveness of Department of Defense programs and operations.

III. Mission Statement

The Office of the Inspector General promotes integrity, accountability, and improvement of Department of Defense personnel, programs and operations to support the Department's mission and to serve the public interest.

IV. Core Values

- Accountability
- Integrity & Efficiency

V. Organization

The DoD OIG audits, investigates, inspects, and evaluates the programs and operations of the DoD and as a result, recommends policies and process improvements that promote economy, efficiency, and effectiveness in DoD programs and operations. For the last three years, the DoD OIG has achieved \$27.5 billion in savings and \$3.6 billion in recoveries for the nation. The Inspector General (IG) is the only DoD official qualified to issue opinions on the financial

statements of the DoD. The DoD OIG also informs DoD management and Congress about the problems and deficiencies in programs and operations and the progress of corrective actions.

As of 1 Feb 06

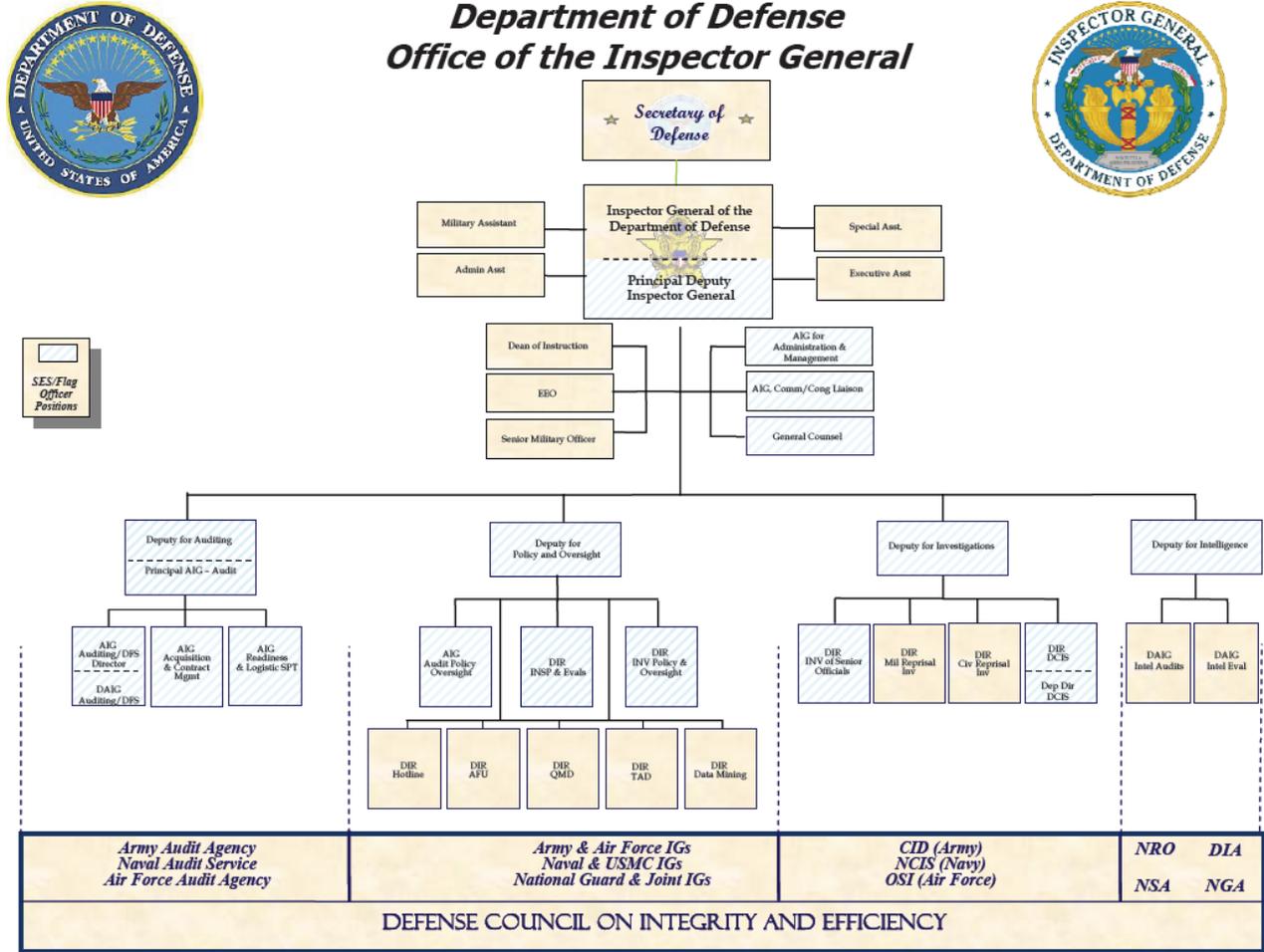


Figure 1. DoD OIG’s Organizational Structure as of September 30, 2006

DoD OIG is organized under four Deputies. They are Auditing, Investigations, Policy and Oversight, and Intelligence.

Auditing

Section 3 (d) of the Inspector General Act establishes the requirement for the audit function within the Office of the Inspector General. The Office of the Deputy Inspector General for Auditing (ODIG-AUD) conducts audits on all facets of DoD operations. The work results in recommendations for reducing costs, eliminating fraud, waste, and abuse of authority, improving performance, strengthening internal controls, and achieving compliance with laws, regulations,

and policies. Audit topics are determined by law, by requests from the Secretary of Defense and other DoD leadership, by Hotline allegations, by congressional requests, and by internal analyses of risk in DoD programs. The Defense Council on Integrity and Efficiency audit community consists of the DoD OIG, the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency.

Investigations

The Office of the Deputy Inspector General for Investigations (ODIG-INV) comprises the criminal and the administrative investigative components of the DoD OIG. The Defense Criminal Investigative Service (DCIS) is the criminal investigative component of the DoD OIG. The non-criminal investigative units include the Directorate for Investigations of Senior Officials (ISO), the Directorate for Military Reprisal Investigations (MRI), and the Directorate for Civilian Reprisal Investigations (CRI).

The DCIS is tasked with the mission to protect America's warfighters by conducting investigations in support of crucial national defense priorities. DCIS conducts investigations of suspected major criminal violations focusing mainly on terrorism, product substitution/defective parts, cyber crimes/computer intrusion, illegal technology transfer, and other crimes involving public integrity including bribery, corruption, and major theft. DCIS also promotes training and awareness in all elements of the DoD regarding the impact of fraud on resources and programs by providing fraud awareness presentations.

The Defense Criminal Investigative Organizations (DCIOs), comprised of DCIS, the Army Criminal Investigation Command, the Naval Criminal Investigative Service, and the Air Force Office of Special Investigations, protect the military and civilian men and women of the Department by combating crimes, both domestic and overseas, with highly trained special agents, forensic experts, analysts, and support personnel.

Policy and Inspections

Previously established in 2002 as the Office of the Deputy Inspector General for Inspections and Policy (ODIG-I&P), consisting of Audit Policy and Oversight (APO), Investigative Policy & Oversight (IPO), Inspections and Evaluations (I&E), and Defense Hotline, the component was renamed Policy and Oversight (ODIG-P&O) on February 5, 2006, as a result of a DoD OIG reorganization which combined the four I&P components with four other divisions: Quantitative Methods (QMD); Technical Assessment; Audit Follow-up and GAO Affairs; and Data Mining.

The ODIG-P&O provides oversight and policy for Audit and Investigative activities within DoD; manages the DoD Hotline; conducts inspections and evaluations; provides technical, statistical, and quantitative advice and support to DoD OIG projects; conducts data mining; monitors corrective actions taken in response to the DoD OIG and Government Accountability Office (GAO) reports; and serves as DoD central liaison with GAO on reports and reviews regarding DoD programs and activities.

In accordance with the Inspector General Act of 1978, as amended, the Office of Assistant Inspector General for Audit Policy and Oversight (APO), provides policy direction and oversight for audits performed by over 6,500 DoD auditors in twenty-four DoD organizations, ensures appropriate use of non-federal auditors and their compliance with auditing standards and ensures that contracting officials comply with statutory and regulatory requirements when resolving contract audit report recommendations in accordance with DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports." Currently the DoD OIG has 676 auditors assigned to various directorates within the Audit Component.

Intelligence

The Office of the Deputy Inspector General for Intelligence (ODIG-INTEL) audits, reviews, evaluates, and monitors the programs, policies, procedures, and functions of the DoD Intelligence Community and the intelligence-related activities within the DoD Components, primarily at the DoD, Service, and Combatant Command levels, ensuring that intelligence and intelligence-related resources are properly, effectively, and efficiently managed. The ODIG-INTEL also conducts oversight of Service and Defense agency reviews of security and counterintelligence within all DoD test and laboratory facilities.

VI. Budgetary and Financial Aspects

The DoD OIG works closely with the DoD to address long-standing financial management problems and supports the DoD's goal of achieving a favorable audit opinion for the DoD Agency-Wide financial statements. The Under Secretary of Defense (Comptroller)/Chief Financial Officer (CFO) has directed an initiative to improve financial management in the DoD with the stated objective of achieving an unqualified audit opinion on the DoD's financial statements. Also, the DoD OIG continues to support congressional audit requirements for three DoD intelligence agencies and audits of Defense agencies that will help to render a favorable audit opinion on the DoD Agency-Wide financial statements.

Financial Condition

The Department of Defense Inspector General annually assesses the most serious management and performance challenges faced by the DoD based on the findings and recommendations of audits, inspections, and investigations conducted during the year.

The DoD OIG's annual appropriation for FY 2006 was \$206.8 million. During the FY 2006 the DoD OIG received an additional \$8.8 million to fund such initiatives like Global War On Terror (GWOT), audits of relief activities related to Hurricane Katrina, and the DoD OIG's relocation as of result of the Base Realignment and Closure (BRAC) report.

Fund Balance with Treasury increased by \$6.7 million from, FY 2005 to FY 2006 because the DoD OIG received additional funds in order to successfully meet the Department of Defense's goal to obtain clean audit opinions on its financial statements by FY 2007. The additional funding will allow the Defense Financial Auditing Service to grow ahead of the increasing number of assertions as proclaimed by DoD Components stating that their financial statements

and systems are ready for audit. Funds will be used to increase auditor staff, expand field offices, and provide for essential operational costs.

Limitations to the Financial Statements

The financial statements have been prepared to report the financial position and results of operations for the entity. These statements have been prepared from the books and records of the entity, in accordance with the formats prescribed by the Office of Management and Budget, and guidance provided by the Department and in accordance with mandatory reporting requirements and regulations.

The statements presented should be read with the realization that they are for a component of the U.S. Government, Department of Defense, or a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation that provide resources to do so.

VII. Systems, Controls, and Legal Compliance

DoD OIG Systems

The DoD OIG depends on a variety of DoD systems to record, summarize, and report its financial information. Some of the systems include:

- WHS (Washington Headquarters Services) Allotment and Accounting System (WAAS)
- Defense Departmental Reporting System (DDRS)
- Headquarters Accounting and Reporting System (HQARS)
- CFO Loan and Reconciliation System (CLRS)

Currently, the DoD's systems are not in full compliance with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. In its effort to ensure the Department-wide critical accounting, finance, and feeder systems comply with federal financial management requirements, the DoD established the Senior Financial Management Oversight Council (SFMOC). This council oversees and provides guidance in the implementation of the Financial and Feeder Systems Compliance.

Due to the complexity and multiple systems currently used by DoD to process its financial transactions and prepare its financial statements, it will take time for its financial accounting systems to become fully compliant with applicable laws and regulations, including FFMIA.

Controls and Legal Compliance

DoD OIG's transactions are executed in accordance with budgetary and financial standards and other requirements, consistent with the purpose authorized and are recorded in accordance with federal accounting standards, generally accepted accounting principles, and Statements of Federal Accounting Standards. Assets are properly acquired and used, safeguarded to deter theft, accidental loss or unauthorized disposition, and fraud. Performance measurement information is adequately supported.

The DoD OIG's senior management evaluated the system of internal accounting and administrative control, in effect during the fiscal year ending September 30, 2006, in accordance with the guidance in Office of Management and Budget (OMB) Circular No. A-123 (Revised), "Management Accountability and Control," dated June 21, 1995, as implemented by DoD Directive 5010.38, "Management Control (MC) Program," dated August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," dated August 28, 1996. The OMB guidelines were issued in consultation with the Comptroller General of the United States, as required by the "Federal Managers' Financial Integrity Act of 1982." Included is an evaluation of whether the system of internal accounting and administrative control for the Office of the Inspector General is in compliance with standards prescribed by the Comptroller General.

The objectives of the system of internal accounting and administrative control of the Office of the Inspector General are to provide reasonable assurance that:

- The obligations and costs are in compliance with applicable laws.
- Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation.
- Revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of reliable accounting, financial, and statistical reports and to maintain accountability over the assets.

The results indicate that the Office of the Inspector General system of internal accounting and administrative control, in effect during the fiscal year ending September 30, 2006, provides reasonable assurance that management controls are in place, operating effectively, and being used.

VIII. Performance Information

Improve the economy, efficiency, and effectiveness of DoD personnel, programs and operations.

Objectives:

- Recommend solutions to resolve identified risks and weaknesses.
- Provide independent, objective, and relevant information to the Department, Congress, other Government agencies, and the public.

Eliminate fraud, waste, and abuse in the programs and operations of the Department.

Objectives:

- Promote ethics and integrity within the Department.
- Prevent and detect fraud, waste, and abuse.
- Provide independent, objective, and relevant information to the Department, Congress, other Government agencies, and the public.
- Promote public confidence in DoD leadership and programs.

Improve the efficiency and effectiveness of DoD OIG products, processes, and operations.

Objectives:

- Establish short and long term priorities for the DoD OIG.
- Achieve President's Management Agenda initiatives.
- Ensure accountability for mission accomplishment and strategic human capital management and merit system principles.
- Improve the planning and use of DoD OIG resources to ensure relevant and timely information to senior-level decision makers on critical issues.
- Enhance the follow-up process to focus on outcomes and impacts.
- Identify opportunities for improvement of Component unique operations.

Strategic Plan

The DoD OIG's Strategic Plan supports the President's Management Agenda (PMA) and the Department's mission. Its key goal is to improve DoD operations by promoting efficient, effective, and economical operations, including full and timely implementation of the PMA's primary goals and objectives, the Secretary's top priorities, and the GAO's High Risk Areas.

The DoD OIG Strategic Plan includes goals to improve the economy, efficiency and effectiveness of DoD personnel, programs, and operations; eliminate fraud, waste, and abuse in the programs and operations of the Department; and improve the efficiency and effectiveness of DoD OIG products, processes and operations. Key objectives include: providing independent, objective, and relevant information to the Department, Congress, other government agencies and the public; promoting ethics and integrity within the Department; preventing and detecting fraud, waste, and abuse; achieving the PMA initiatives; ensuring accountability for mission accomplishment and strategic human capital management and merit system principles; and improving the planning and use of DoD OIG resources to ensure relevant and timely information to senior-level decision makers on critical issues. To monitor performance against the plan, the DoD OIG complies with the Government Performance and Results Act of 1993, as amended, and tracks goal attainment on a quarterly basis to help ensure progress and results are realized to ensure a return on investment of taxpayer dollars.

IX. Results

In FY 2006, the ODIG-AUD produced 120 reports which claimed potential monetary benefits totaling \$75.2 million. In FY 2006, ODIG-AUD also achieved \$913.7 million in monetary benefits from reports issued in FY 2006 and earlier (i.e., funds were put to better use because of actions completed on audit recommendations). Since FY 2004, there has been an average return on investment of \$4.1 million in monetary benefits achieved per DoD OIG auditor each year. As of September 30, 2005, the Department has approximately 1,300 acquisition category I-IV programs with an estimated total cost of \$2.3 trillion. Increased audit coverage of major acquisition programs and contracting issues could lead to greater monetary benefits for the Department and the mitigation of institutional risk. The Congress and senior DoD officials requested and used the IG audit products on BRAC, Homeland Security, information system projects, readiness, chemical and biological defense, acquisition processes, information assurance, maintenance, supply management, use of government credit cards, financial

management, health care, and environmental issues. One initiative in progress is the implementation of customer satisfaction surveys to ensure that the result of Audit's work adds maximum value to the Department.

Priority demands on audit resources include:

- The Chief Financial Officer's Act of 1990, as amended by the Federal Financial Management Act of 1994;
- The Intelligence Authorization Act for FY 2002 which requires the DoD OIG to audit the form and content of the financial statements of the National Security Agency, National Geospatial-Intelligence Agency, and Defense Intelligence Agency;
- Reports required or requested by Congress and senior DoD officials, or resulting from Hotline allegations; and
- Efforts to improve DoD processes which, while beneficial, do not result in reports that can be reflected in IG productivity statistics.

The criteria for evaluating the DoD OIG's investigative operations include the number of indictments, convictions, fines; the amount of recoveries and restitutions; and the number of administrative investigations conducted or overseen. Using those criteria, cases in which Defense Criminal Investigative Service (DCIS) participated in FY 2005 and the first 10 months of FY 2006, resulted in 702 criminal indictments, 574 convictions; and over \$2.2 billion in criminal, civil, and administrative recoveries (excluding headquarters and field managers, an average of \$4.41 million per agent, per year. Since inception, DCIS has been responsible for over \$11.2 billion in criminal, civil and administrative recoveries. The current measure of the DCIS' effectiveness is to conduct significant criminal investigations in support of crucial national defense priorities. The DCIS accomplishes this by: ensuring that investigative resources are used effectively and efficiently; placing primary emphasis on investigations of terrorism, product substitution/defective parts, computer crimes targeting the Global Information Grid, illegal technology transfer, and public corruption; and identifying offenders and/or detecting, disrupting, or dismantling the associated criminal activities.

It is difficult to quantify the results of criminal investigative operations. For example, in bribery and kickback cases, the dollar impact on the cost of a major contract is not readily identifiable, yet bribes and kickbacks undermine the integrity and efficiency of departmental programs and operations. The DoD OIG also identifies areas of criminal vulnerability regarding DoD activities and ensures that the Department takes action to correct deficiencies. Another valuable byproduct of criminal investigative activities is the deterrent effect, which results from an awareness of the vigorous pursuit of violations of the law. The DoD OIG attempts to ensure that the Department takes appropriate administrative action, whether or not prosecutions are obtained. The DoD OIG seeks to have disreputable contractors suspended or debarred and to recover monies due to the Department.

Whistleblower protection for military service members, DoD nonappropriated fund employees, and DoD contractor employees is the statutorily-mandated mission of the Directorate for MRI. In FY 2006, MRI closed 506 cases, which included in-house cases and oversight reviews of Service IG cases. Of these, 308 cases were closed after preliminary inquiries and 198 cases

received full investigations. Forty full investigations resulted in one or more substantiated reprisal allegations, and 20 investigations found procedural violations under the DoD directive pertaining to referral of military members to involuntary mental health evaluations. Faced with a continuing increase in whistleblower reprisal allegations received by both the DoD OIG and the Military Department Inspectors General (from 320 complaints received in FY 1997 to 554 complaints received in FY 2006), the MRI strives to implement policies and procedural efficiencies to improve the timeliness in processing and resolving such allegations. The Directorate conducts training workshops on the conduct of military whistleblower reprisal investigations for representatives of the Military Services, the Joint Chiefs of Staff, and other defense agencies.

Whistleblower protection for civilian appropriated fund personnel is the primary mission of the Directorate for CRI. In FY 2006, its second year of operation, the Directorate closed five cases, and docketed 20 cases. In FY 2007, CRI expects 50 preliminary inquiries and 20 accepted cases, with the highest priority given to contractor fraud and abuse within the Defense Intelligence and counter-intelligence communities.

The Directorate for Investigations of Senior Officials (ISO) completed 70 inquiries or investigations in FY 2006. ISO also oversaw 400 investigations by DoD components. ISO is also evaluated by the impact those investigations may have on public confidence in DoD leaders and ultimately on national security. Investigative impact may be evaluated by the percentage of investigations that were of significance to DoD or congressional leaders, and the percentage of investigations that substantiated alleged misconduct. Thirty percent of investigations conducted by ISO in FY 2006 had significant media, SECDEF, or congressional interest, with results provided directly to the SECDEF or members of Congress. Examples include investigations into alleged conflicts of interest on the part of senior DoD officials, alleged mismanagement of an aircraft procurement program, and the alleged failure to use intelligence data obtained by the Able Danger anti-terrorist program. Over 15 percent of the investigations substantiated allegations against senior officials and resulted in immediate removal from command, reprimands, reductions in rank, and reimbursement to the Government, thereby demonstrating that the Department holds senior leaders accountable for misconduct. Both statistics indicate the increasing complexity of allegations involving senior officials and associated requirement for comprehensive, manpower intensive investigative work. Recent examples in the area of senior official inquiries include substantiated allegations of using Government property for unauthorized purposes, violating of fraternization regulations, taking official action for private gain, accepting gifts from prohibited sources, and taking unauthorized personnel actions. As part of its responsibility to fully inform the President and Senate of adverse information concerning senior officials being nominated for promotion, reassignment, or other action, the office conducted almost 3,000 name checks on DoD senior officials in the past year. The Senate Armed Services Committee relies exclusively on checks completed by ISO before confirming military officer promotions.

The ODIG-P&O operations are evaluated on the reviews conducted, as measured by the number of reports issued; the Hotline activities reported; voluntary disclosures processed; subpoenas processed; and outcomes achieved. Inspectors and evaluators also facilitate process improvement activities that do not result in separate formal reports, such as advising the Iraqi Ministry of

Defense Inspector General, assisting the coalition forces in Afghanistan build self-sustaining Afghan institutions, developing joint doctrine and training for Combatant Command IGs, recommending safety initiatives to prevent accidents, advising DoD managers, and promoting communications and collaboration among the various DoD IG communities.

In FY 2006, APO commented on 15 exposure draft policy documents within established timeframes. The draft policy documents were from within DoD and outside DoD including comments on Government Auditing Standards, American Institute of Certified Public Accountant (AICPA) standards, Federal Accounting Standards Advisory Board standards and Office of Management and Budget Circulars and Bulletins. The APO detailed one staff member for five months to the Government Accountability Office as part of a training assignment to work on the Government Auditing Standards and standards related tools and training course development. The APO also reviewed three single audit reports of Certified Public Accountant (CPA) firms' work of non-profit organizations and referred one CPA firm to the AICPA for substandard work. The APO also issued reports on Hotline reviews with recommendations for improvement and issued the overall report on the external reviews of the quality control systems of the Military Department Audit Agencies. The APO provided training to over 180 personnel from various President's Council on Integrity and Efficiency (PCIE) and Executive Council on Integrity and Efficiency (ECIE) organizations on the PCIE external peer review process and reporting, and to 30 Army Internal Review evaluators on attest services. In addition, the APO provided advice assistance on the DoD IG external peer review of the Department of Homeland Security Office of Inspector General, the Base Realignment and Closure Naval Air Station Oceana report to the President and Congress, and Veterans Administration Office of Inspector General on external peer reviews. APO also published a pamphlet on "What Makes a DoD Audit Organization World Class?", IGDPH 7600.2.

In FY 2006, IPO accepted six voluntary disclosures, closed eight cases and issued 204 subpoenas. IPO reviewed criminal investigations of prisoner and detainee abuse in Iraq, Afghanistan, and Cuba; the investigation, arrest, and imprisonment of a Muslim military chaplain that touches a broad range of U.S. Government agencies; the department's response and investigation of a friendly fire death of a soldier and former professional football player; and the investigation of a reported suicide of an Army soldier in Afghanistan. Each of these projects regularly captures keen congressional and national media interest. They are referred to this office after dissatisfaction with previous investigations or responses because the Office of the Inspector General is considered an honest broker of information.

In FY 2006, the DoD Hotline handled an average of 1,200 calls and letters per month, reflecting approximately a workload increase of 35 percent since September 11, 2001.

In FY 2006, the QMD analysts have provided expert technical support to 52 projects and have certified the technical defensibility of 116 reports.

The ODIG-INTEL focuses on assessing the efficient, effective, and appropriate use of intelligence personnel and resources with emphasis on support to the warfighter and national command authority. In FY 2006, ODIG-INTEL provided DoD leadership and Congress 16 intelligence evaluation and audit reports such as Nuclear Command and Control; Defense Human Intelligence; Testimony to the 9-11 Commission; National Security Agency programs

and initiatives; National Geospatial-Intelligence Agency system acquisitions; Detainee Abuse; Special Access Programs; and Counterintelligence. Congressional directed actions or requests, management requests, or DoD Hotline complaints initiate 71 percent of ongoing projects. The other 29 percent comes from a proactive process of identifying projects to promote effective operations and ensure efficient use of resources in vital intelligence and related mission areas in support of the Department's goals and the DoD OIG Strategic Plan.

In FY 2006, the ODIG-INTEL developed and implemented a DIG-INTEL Strategic Plan to supplement the DoD OIG Strategic Plan that included performance measures and metrics. The ODIG-INTEL also met its performance measure to plan, staff, and manage projects so that projects are completed within an average of 330 days (actual average was 248 days, which is 23 percent less than the average of 323 days for the prior period). While this performance was in part, a result of an unusual large number of projects with small timeframes, ODIG-INTEL will continue to define project scope and objectives for FY 2007 and FY 2008 projects in order to effect additional efficiencies in project cycle time. ODIG-INTEL will continue participating in quarterly meetings of the Intelligence Community Inspectors General (ICIG) Forum and chair the Joint Intelligence Oversight Coordination Group (JIOCG) to prevent duplication and overlap between the DoD OIG, Service audit agencies, Military IGs, and other Intelligence Agencies' components, or jointly with DoD intelligence agency IGs and Intelligence Community IG Forum members.

X. Events, Trends, and Risks

Between September 11, 2001, and September 2005, the United States has obligated \$268 billion in support of the GWOT. Overseeing these expenditures, the acquisition of massive amounts of materiel and equipment involved to support actions in Afghanistan and Iraq, and the extensive logistics to move these resources poses tremendous challenges for the services. The work of the DoD oversight community has been and will continue to be critical to the outcome of the DoD-wide GWOT efforts.

The DoD OIG opened a field office in Qatar in March 2006. The staff in the Qatar office has been assigned to conduct audits, inspections, and investigations as required in Iraq, Afghanistan, Kuwait, and Qatar to support the operational commanders. The reviews done by this staff will cover critical issues that are important to the Department in the areas of readiness, logistics, force management, contracting, and financial management.

The DoD OIG is conducting audits in the Southwest Asia region launched from both the Qatar field office and from the Continental United States (CONUS). Those audits include the Commander's Emergency Response Program (CERP), Equipment Status of Deployed Forces, Information Operations in Southwest Asia, Joint Service Small Arms Program, and Management of the Iraq Security Forces Fund.

As the criminal investigative arm for the DoD OIG, the DCIS, as part of a Department of Justice Task Force, is involved in the review of allegations regarding matters that have occurred in Iraq. However, the bulk of their investigative activities occur in CONUS where corporate headquarters of DoD contractors, key evidence, and Department of Justice prosecutive support are located. With the deployment of the DoD OIG Qatar Field Office, DCIS expects a significant

increase in criminal fraud referrals and a concomitant increase in investigator presence in the area. DCIS also conducts investigations of the illegal diversion, theft, or movement of strategic technologies and U.S. Munitions List items to proscribed nations, and to terrorist organizations that pose a threat to national security. Technology Protection-related investigations have grown to encompass approximately 20 percent of DCIS' active caseload.

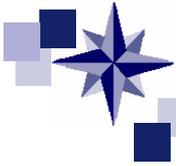
The DoD has been an active participant in the disaster recovery and relief efforts for areas of the Gulf Coast devastated by Hurricanes Katrina, Rita, and Wilma this past Fall. As a result, the DoD OIG has been working in close coordination with other Inspectors General through the PCIE to ensure effective oversight in the utilization of resources in the relief and recovery efforts.

The DoD OIG has eleven ongoing audits related to Hurricane Katrina. These audits cover contracts on ice, water, temporary roofs, subsistence, and construction capabilities; expanded micro-purchase authority for purchase card transactions; effects on information technology resources in affected areas; accounting and oversight of obligations and expenditures related to DoD Hurricane Katrina efforts; and the use of DoD resources supporting recovery and relief efforts.

In addition to audit coverage, DCIS has received 21 criminal allegations related to Hurricane Katrina. Of the 21 allegations, 8 were determined to be unfounded; 3 were declined for prosecution; 3 were referred to other federal agencies; 1 is being examined to determine if a case initiation is warranted; and 6 resulted in opened cases. The opened cases deal with bribery, kickbacks, and possible product substitution; three of these cases relate to debris removal, and one relates to blue roofs. The allegations originated from Government agencies, subcontractors, and private citizens.

Significant Financial Crimes

The DoD loses millions of dollars annually because of financial crime, public corruption, and major thefts. Through the investigative efforts of DCIO agents, abuses in the procurement process, such as the substitution of inferior products, overcharges, bribes, kickbacks, and cost mischarging are exposed. Additionally, the DCIOs have partnered with acquisition and financial agencies to proactively identify areas of vulnerability.



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Independent Auditors' Report

Introduction

We have audited the balance sheet of the Department of Defense Office of the Inspector General (DoD OIG) as of September 30, 2006, and the related statements of net cost, changes in net position, budgetary resources, and financing (the financial statements) for the year then ended. The objective of our audit was to express an opinion on the fair presentation of those financial statements. In connection with our audit, we also considered the DoD OIG's internal control over financial reporting and tested the DoD OIG's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

As stated in our opinion on the financial statements, we found that the DoD OIG's financial statements as of and for the year ended September 30, 2006, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. Our testing of internal control identified a material weakness in financial reporting. Additionally, we identified matters with a service provider concerning financial management systems and processes that we consider to be material weaknesses in relation to the DoD OIG's financial statements. The financial systems used by the DoD OIG are not in compliance with the requirements of FFMIA.

The results of our tests of compliance with certain provisions of laws and regulations disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*.

The following sections discuss in more detail our report on the DoD OIG's financial statements, our consideration of the DoD OIG's internal control over financial reporting, and our tests of the DoD OIG's compliance with certain provisions of applicable laws and regulations.

Independent Auditors' Report

We have audited the accompanying balance sheet of the DoD OIG as of September 30, 2006, and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended. These financial statements are the responsibility of DoD OIG management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in the Government Auditing Standards, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and the OMB bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of misstatement. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the DoD OIG's internal control over financial reporting. Accordingly, we do not express such an opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the DoD OIG as of September 30, 2006 and its net cost of operations, changes in net position, budgetary resources, and financing for the year ended September 30, 2006, in conformity with accounting principles generally accepted in the United States of America. We did not audit the financial statements as of and for the year ended September 30, 2005, and we do not express an opinion on those statements.

In accordance with *Government Auditing Standards*, we have issued our report dated November 8, 2006 on our consideration of the DoD OIG's internal control over financial reporting and on our tests of compliance with certain provisions of laws, regulations, contracts, agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying required supplementary information, referred to as the Management Discussion and Analysis, is not a required part of the basic financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America, OMB Circular A-136. The supplementary information is the responsibility of DoD OIG management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

Independent Auditors' Report on Internal Control over Financial Reporting and On Compliance and Other Matters Based on Audits Performed in Accordance with Government Auditing Standards

Our responsibility is to express an opinion on the financial statements at and for the year ended September 30, 2006 based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 06-03. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit, we considered the DoD OIG's internal control over financial reporting by obtaining an understanding of the agency's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 06-03 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by FMFIA. Our procedures were not designed to provide assurance on internal control over financial reporting. Consequently, we do not express an opinion thereon.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the agency's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. A material weaknesses, as defined by OMB Bulletin 06-03, is a reportable conditions in which the design or operation of the internal control does not reduce to a relatively low level the risk that errors, fraud or noncompliance in amounts that would be material in relation to the basic financial statements being audited or material to the performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We believe that the following reportable conditions are identified as material weaknesses in financial reporting under the direct control of the DoD OIG. Additionally, we identified matters, related to Defense Finance and Accounting Service's financial management systems used to record, process, summarize and report DoD OIG activities and results that we consider to be material weaknesses in relation to the DoD OIG's financial statements.

Financial Reporting

DoD OIG management relies on the processes that have been designed within the Department to process, record and report on financial transactions. The services for those processes are acquired from the Defense Finance and Accounting Service and discussed in a service level

agreement. However, the fiduciary stewardship and responsibility over financial reporting that is inherent to management remains with DoD OIG. We found that DoD OIG does not 1.) perform adequate managerial review of the information processed by DFAS, 2.) have a process in place to ensure the completeness of the quarterly or year-end financial statements, and 3.) have fundamental processes in place to ensure that transactions initiated are appropriately reviewed and approved.

- We observed that DoD OIG has many activities that replicate the actions taken by their service provider. In some cases the activities are more akin to converting data from one format to another (i.e. PDF to Excel). However, business processes do not exist to independently validate the information being processed by the service provider. Consequently, the analysis of the information at the financial reporting level is not adequately performed.
- Our analysis of the financial statements identified that DoD OIG does not have a business process in place to identify, estimate, record and validate the adequacy of accruals at each reporting period. DoD OIG developed accruals for the first time for the September 30, 2006 financial statements. The only accrual data that was included in their financial statements previously was for payroll and other Department level data, rather than for DoD OIG's operational transactions. Additionally, DoD OIG in conjunction with their service provider have not fully documented the crosswalks used to develop the DD 1176 from the WAAS general ledger. This report serves as an integral piece of the audit trail from the general ledger to the Statement of Budgetary Resources. Using alternative procedures we were able to validate the statement.
- We observed that DoD OIG does not have business practices in place to perform adequate management review of transactions recorded to their books. For example, there are no business processes to review the validity of lease or facilities costs recorded nor is there a process to validate the amounts recorded for personnel benefits costs. DoD OIG did not realize that management reviews and validation processing controls were essential to fulfill their management stewardship responsibilities.

These conditions create a vulnerability for material misstatement, lack of reliability and completeness of the DoD OIG's financial statements; thus we classified this condition as a material weakness in financial reporting.

DoD Systems

As has been reported in previous years, DoD OIG's service providers do not have systems that retain transaction level detail data necessary to support DoD OIG's financial statement amounts. The basic accounting system captures data using object classes, not general ledger accounts. The object classes are translated into DoD general ledger account totals using an automated program. As a result of the translation, the service provider must post numerous, often material adjustments to re-create beginning balances in net position accounts, reconcile proprietary accounts to budgetary accounts, and create a trial balance in U.S. Standard General Ledger (USSGL) format.

This issue is a part of long-standing, well-documented financial management systems weaknesses that have been reported by the DoD OIG's Defense Financial Auditing Service and the Government Accountability Office in previous years' reports on the DoD financial statements and the government-wide financial statements, respectively. The Department does not maintain systems that comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S.S.G.L. at the transaction level.

The results of our tests of compliance with certain provisions of laws and regulations disclosed no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 06-03.

As noted above, Departmental financial management systems did not substantially comply with Federal financial management system requirements, applicable Federal accounting standards, or the SGL at the transaction level.

We noted certain matters that we reported to DoD OIG management in a separate letter dated November 8, 2006.

Agency Comments

The DoD OIG provided comments to the Auditors' Report where they generally concurred with each observation made related to Financial Reporting. The DoD OIG comments and their planned corrective actions are included in Appendix A to this report.

This report is intended solely for the information and use of the management of the DoD OIG, DoD, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Acuity Consulting Inc.
Acuity Consulting, Inc.
November 8, 2006

Financial Statements

**Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
CONSOLIDATED BALANCE SHEET
As of September 30**

	2006	(Unaudited) 2005
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	\$ 42,303,166	\$ 35,610,108
Accounts Receivable (Note 4)	203	0
Total Intragovernmental Assets	\$ 42,303,369	\$ 35,610,108
Accounts Receivable, Net (Note 4)	49,032	51,726
General Property, Plant and Equipment, Net (Note 5)	0	109,029
Other Assets	254,267	200,304
TOTAL ASSETS	\$ 42,606,668	\$ 35,971,167
LIABILITIES (Note 6)		
Intragovernmental:		
Accounts Payable (Note 7)	\$ 1,486,328	\$ 0
Other Liabilities (Note 8)	2,534,963	2,096,480
Total Intragovernmental Liabilities	\$ 4,021,291	\$ 2,096,480
Accounts Payable (Note 7)	\$ 1,484,490	\$ 687,919
Military Retirement and Other Federal Employment Benefits (Note 9)	6,399,249	5,011,404
Other Liabilities (Note 8)	16,103,102	14,878,578
TOTAL LIABILITIES	\$ 28,008,132	\$ 22,674,381
NET POSITION		
Unexpended Appropriations - Other Funds	19,000,490	13,825,118
Cumulative Results of Operations - Other Funds	(4,401,954)	(528,332)
TOTAL NET POSITION	\$ 14,598,536	\$ 13,296,786
TOTAL LIABILITIES AND NET POSITION	\$ 42,606,668	\$ 35,971,167

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
CONSOLIDATED STATEMENT OF NET COST
For the Years Ended September 30

	2006	(Unaudited) 2005
Program Costs		
Gross Costs	\$ 221,793,303	\$ 203,775,200
(Less: Earned Revenue)	39,535	(3,084,065)
Net Program Costs	<u>\$ 221,832,838</u>	<u>\$ 200,691,135</u>
Cost Not Assigned to Programs	0	0
(Less: Earned Revenue Not Attributable to Programs)	0	0
Net Cost of Operations	<u><u>\$ 221,832,838</u></u>	<u><u>\$ 200,691,135</u></u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
For the Years Ended September 30

	2006	(Unaudited) 2005
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances (Unaudited)	\$ (528,332)	\$ (3,206,581)
Budgetary Financing Sources:	0	0
Appropriations received	0	0
Appropriations transferred-in/out (+/-)	0	0
Other adjustments (rescissions, etc.) (+/-)	0	0
Appropriations used	207,209,925	192,267,680
Nonexchange revenue	0	0
Donations and forfeitures of cash and cash equivalents	0	0
Transfers-in/out without reimbursement (+/-)	0	0
Other budgetary financing sources (+/-)	0	0
Other Financing Sources:		
Donations and forfeitures of property	0	0
Transfers-in/out without reimbursement (+/-)	0	0
Imputed financing from costs absorbed by others	10,762,276	10,336,663
Other (+/-)	(12,985)	765,041
Total Financing Sources	<u>217,959,216</u>	<u>203,369,384</u>
Net Cost of Operations (+/-)	<u>221,832,838</u>	<u>200,691,135</u>
Net Change	<u>(3,873,622)</u>	<u>2,678,249</u>
Ending Balances	<u>\$ (4,401,954)</u>	<u>\$ (528,332)</u>
 UNEXPENDED APPROPRIATIONS		
Beginning Balances (Unaudited)	\$ 13,825,118	\$ 8,575,925
Budgetary Financing Sources:		
Appropriations received	215,323,000	204,710,000
Appropriations transferred-in/out (+/-)	143,000	(6,939,000)
Other adjustments (rescissions, etc) (+/-)	(3,080,704)	(254,127)
Appropriations used	(207,209,924)	(192,267,680)
Nonexchange revenue	0	0
Donations and forfeitures of cash and cash equivalents	0	0
Transfers-in/out without reimbursement (+/-)	0	0
Other budgetary financing sources (+/-)	0	0
Other Financing Sources:		
Donations and forfeitures of property	0	0
Transfers-in/out without reimbursement (+/-)	0	0
Imputed financing from costs absorbed by others	0	0
Other (+/-)	0	0
Total Financing Sources	<u>5,175,372</u>	<u>5,249,193</u>
Net Cost of Operations (+/-)	<u>0</u>	<u>0</u>
Net Change	<u>5,175,372</u>	<u>5,249,193</u>
Ending Balances	<u>\$ 19,000,490</u>	<u>\$ 13,825,118</u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the Years Ended September 30

	2006	(Unaudited)
		2005
BUDGETARY FINANCING ACCOUNTS		
BUDGETARY RESOURCES:		
Unobligated balance, brought forward, October 1 (Unaudited)	\$ 5,337,402	\$ 3,841,998
Recoveries of prior year unpaid obligations	13,768,841	2,601,921
Budget authority		
Appropriation	215,323,000	204,710,000
Borrowing authority	0	0
Contract authority	0	0
Spending authority from offsetting collections		
Earned		
Collected	(50,028)	11,987,822
Change in receivables from Federal sources	10,493	(8,903,757)
Change in unfilled customer orders		
Advance received	0	0
Without advance from Federal sources	15,754	(395,187)
Anticipated for rest of year, without advances	0	0
Previously unavailable	0	0
Expenditure transfers from trust funds	0	0
Subtotal	<u>215,299,219</u>	<u>207,398,878</u>
Nonexpenditure transfers, net, anticipated and actual	143,000	(6,939,000)
Temporarily not available pursuant to Public Law	0	0
Permanently not available	(3,080,704)	(254,127)
Total Budgetary Resources	<u><u>\$ 231,467,758</u></u>	<u><u>\$ 206,649,670</u></u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
COMBINED STATEMENT OF BUDGETARY RESOURCES - Continued
For the Years Ended September 30

	2006	(Unaudited) 2005
Status of Budgetary Resources:		
Obligations incurred:		
Direct	\$ 215,675,991	\$ 198,623,390
Reimbursable	208,378	2,688,878
Subtotal	<u>215,884,369</u>	<u>201,312,268</u>
Unobligated balance:		
Apportioned	7,488,428	3,532,708
Exempt from apportionment	0	0
Subtotal	<u>7,488,428</u>	<u>3,532,708</u>
Unobligated balance not available	8,094,961	1,804,694
Total status of budgetary resources	<u>\$ 231,467,758</u>	<u>\$ 206,649,670</u>
Change in Obligated Balance:		
Obligated balance, net		
Unpaid obligations, brought forward, October 1 (Unaudited)	\$ 30,284,618	\$ 21,583,678
Less: Uncollected customer payments from Federal sources, brought forward, October 1 (Unaudited)	<u>(11,912)</u>	<u>(9,310,857)</u>
Total unpaid obligated balance	30,272,706	12,272,821
Obligations incurred net (+/-)	\$ 215,884,369	\$ 201,312,268
Less: Gross outlays	(205,642,210)	(190,009,407)
Obligated balance transferred, net		
Actual transfers, unpaid obligations (+/-)	0	0
Actual transfers, uncollected customer payments from Federal sources (+/-)	<u>0</u>	<u>0</u>
Total Unpaid obligated balance transferred, net	0	0
Less: Recoveries of prior year unpaid obligations, actual	(13,768,841)	(2,601,921)
Change in uncollected customer	(26,247)	9,298,944
Obligated balance, net, end of period		
Unpaid obligations	26,757,937	30,284,618
Less: Uncollected customer payments (+/-) from Federal sources (-)	<u>(38,159)</u>	<u>(11,912)</u>
Total, unpaid obligated balance, net, end of period	26,719,778	30,272,706
Net Outlays		
Net Outlays:		
Gross outlays	205,642,210	190,009,407
Less: Offsetting collections	50,027	(11,987,822)
Less: Distributed Offsetting receipts	0	0
Net Outlays	<u>\$ 205,692,237</u>	<u>\$ 178,021,585</u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
CONSOLIDATED STATEMENT OF FINANCING
For the Years Ended September 30

	2006	(Unaudited) 2005
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations incurred	\$ 215,884,369	\$ 201,312,268
Less: Spending authority from offsetting collections and recoveries (-)	<u>(13,745,060)</u>	<u>(5,290,798)</u>
Obligations net of offsetting collections and recoveries	202,139,309	196,021,470
Less: Offsetting receipts (-)	<u>0</u>	<u>0</u>
Net obligations	<u>202,139,309</u>	<u>196,021,470</u>
Other Resources		
Donations and forfeitures of property	0	0
Transfers in/out without reimbursement (+/-)	0	0
Imputed financing from costs absorbed by others	10,762,276	10,336,663
Other (+/-)	<u>(12,985)</u>	<u>765,042</u>
Net other resources used to finance activities	<u>10,749,291</u>	<u>11,101,704</u>
Total resources used to finance activities	\$ 212,888,600	\$ 207,123,174
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided		
Undelivered Orders (-)	6,038,585	(6,442,667)
Unfilled Customer Orders	15,754	(395,187)
Resources that fund expenses recognized in prior periods	0	(83,952)
Budgetary offsetting collections and receipts that do not affect net cost of operations	0	0
Resources that finance the acquisition of assets	0	0
Other resources or adjustments to net obligated resources that do not affect net cost of operations (+/-)	<u>12,985</u>	<u>(765,042)</u>
Total resources used to finance items not part of the net cost of operations	\$ 6,067,324	\$ (7,686,848)
Total resources used to finance the net cost of operations	\$ 218,955,924	\$ 199,436,326
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Period:		
Increase in annual leave liability	\$ 989,732	\$ 963,798
Increase in environmental and disposal liability	0	0
Upward/Downward reestimates of credit subsidy expense (+/-)	0	0
Increase in exchange revenue receivable from the public (-)	0	0
Other (+/-)	<u>1,778,153</u>	<u>171,239</u>
Total components of Net Cost of Operations that will require or generate resources in future periods	2,767,885	1,135,037
Components not Requiring or Generating Resources:		
Depreciation and amortization	109,029	119,772
Other	<u>0</u>	<u>0</u>
Total components of Net Cost of Operations that will not require or generate resources	<u>109,029</u>	<u>119,772</u>
Total components of net cost of operations that will not require or generate resources in the current period	\$ 2,876,914	\$ 1,254,809
Net Cost of Operations	\$ <u>221,832,838</u>	\$ <u>200,691,135</u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
CONSOLIDATED STATEMENT OF FINANCING - Continued
For the Years Ended September 30

	2006	(Unaudited) 2005
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Period:		
Increase in annual leave liability	989,732	963,798
Increase in environmental and disposal liability	0	0
Upward/Downward reestimates of credit subsidy expense (+/-)	0	0
Increase in exchange revenue receivable from the public (-)	0	0
Other (+/-)	<u>1,778,153</u>	<u>171,239</u>
Total components of Net Cost of Operations that will require or generate resources in future periods	2,767,885	1,135,037
Components not Requiring or Generating Resources:		
Depreciation and amortization	109,029	119,772
Other	<u>0</u>	<u>0</u>
Total components of Net Cost of Operations that will not require or generate resources	<u>109,029</u>	<u>119,772</u>
Total components of net cost of operations that will not require or generate resources in the current period	\$ 2,876,914	\$ 1,254,809
Net Cost of Operations	<u>\$ 221,832,838</u>	<u>\$ 200,691,135</u>

Notes to the Basic Statements**NOTE 1. SIGNIFICANT ACCOUNTING POLICIES****1.A. Basis of Presentation**

These financial statements have been prepared to report the financial position and results of operations of the Department of Defense Office of the Inspector General (DoD OIG), as required by the “Chief Financial Officers Act of 1990,” expanded by the “Government Management Reform Act of 1994,” and other appropriate legislation. The financial statements have been prepared from the books and records of the DoD OIG in accordance with the “DoD Financial Management Regulation,” OMB Bulletin No. 01-09, “Form and Content of Agency Financial Statements,” and Federal GAAP. The accompanying financial statements account for all resources for which the DoD OIG is responsible except that information relative to classified assets, programs, and operations has been excluded from the statements or otherwise aggregated and reported in such a manner that it is no longer classified. The DoD OIG’s financial statements are in addition to the financial reports prepared pursuant to OMB directives that are used to monitor and control the use of budgetary resources.

1.B. Description of the Reporting Entity

The Department of Defense Inspector General (DoD Directive 5106.1), under the provisions set forth by Public Law 95-452, serves as an independent and objective official in the Department of Defense who is responsible for conducting, supervising, monitoring, and initiating audits, investigations, and inspections relating to programs and operations of the Department of Defense. The Inspector General provides leadership and coordination and recommends policies for activities designed to promote economy, efficiency, and effectiveness in the administration of, and to prevent and detect fraud and abuse in, such programs and operations. The Inspector General is also responsible for keeping the Secretary of Defense and the Congress fully and currently informed about problems and deficiencies relating to the administration of such programs and operations and the necessity for, and progress of, corrective action.

1.C. Appropriations

The DoD OIG’s appropriations and funds are general funds. These appropriations and funds are used to support the resources that have been used in the course of executing the DoD OIG’s mission.

General funds are used for financial transactions arising under congressional appropriations, including, operation and maintenance, research and development, GWOT, BRAC and procurement accounts.

1.D. Basis of Accounting

The Defense Finance and Accounting Service (DFAS) provides financial management services to the Office of the Inspector General. Many of the DoD’s financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of Federal GAAP

for federal agencies. The DoD has undertaken efforts to determine the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with all elements of Federal GAAP. One such action is the current revision of its accounting systems to record transactions based on the United States Government Standard General Ledger (USSGL). Until such time as all of the DoD's General Funds financial and nonfinancial feeder systems and processes are updated to collect and report financial processes as required by Federal GAAP, the DoD's financial data will be based on budgetary transactions (obligations, disbursements, and collections), transactions from nonfinancial feeder systems, and adjustments for known accruals of major items such as payroll expenses, accounts payable, and other accrued liabilities. However, these financial statements are presented on the accrual basis of accounting as required.

1.E. Revenues and Other Financing Sources

Financing sources for general funds are provided primarily through congressional appropriations that are received on both an annual and a multiyear basis. When authorized, these appropriations are supplemented by revenues generated by sales of goods or services through a reimbursable order process. The DoD OIG recognizes revenue as a result of costs incurred or services performed on behalf of other federal agencies and the public. Revenue is recognized when earned under the reimbursable order process.

1.F. Recognition of Expenses

For financial reporting purposes, the DoD policy requires the recognition of operating expenses in the period incurred. However, because the DoD OIG's financial and nonfinancial feeder systems were not designed to collect and record financial information on the full accrual accounting basis, accrual adjustments are made for major items such as payroll expenses and accounts payable. Expenditures for capital and other long-term assets are not recognized as expenses in the DoD OIG's operations until depreciated in the case of Property, Plant and Equipment (PP&E). Net increases or decreases in unexpended appropriations are recognized as a change in the net position. Certain expenses, such as annual and military leave earned but not taken, are financed in the period in which payment is made.

1.G. Accounting for Intra-governmental Activities

The DoD OIG, as an agency of the federal government, interacts with and is dependent upon the financial activities of the federal government as a whole. Therefore, these financial statements do not reflect the results of all financial decisions applicable to the DoD OIG as though the agency was a stand-alone entity.

The DoD OIG's proportionate share of public debt and related expenses of the federal government are not included. Debt issued by the federal government and the related costs are not apportioned to federal agencies. The DoD OIG's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

The DoD OIG's civilian employees participate in the Civil Service Retirement System (CSRS) and the Federal Employees Retirement Systems (FERS), while military personnel are covered by the Military Retirement System (MRS). Additionally, employees and personnel covered by FERS and MRS also have varying coverage under Social Security. The DoD OIG funds a portion of the civilian and military pensions. Reporting civilian pension under CSRS and FERS retirement systems is the responsibility of the Office of Personnel Management (OPM). The DoD OIG recognizes an imputed expense for the portion of civilian employee pensions and other retirement benefits funded by the OPM in the Statement of Net Cost and recognizes corresponding imputed revenue from the civilian employee pensions and other retirement benefits in the Statement of Changes in Net Position.

1.H. Funds with the U.S. Treasury

The DoD OIG's financial resources are maintained in U.S. Treasury accounts. The collections, disbursements, and adjustments are processed at the Defense Finance and Accounting Services (DFAS) disbursing stations. Each disbursing station prepares monthly reports, which provide information to the U.S. Treasury on check issues, electronic fund transfers, interagency transfers and deposits.

In addition, the DFAS sites submit reports to the Department of the Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The Department of the Treasury then records this information to the applicable Fund Balance with Treasury (FBWT) account maintained in the Treasury's system. Differences between the DoD OIG's recorded balance in the FBWT accounts and Treasury's FBWT accounts sometimes result and are subsequently reconciled.

1.I. Accounts Receivable

Accounts receivable includes accounts, claims, and refunds receivable from other federal entities or from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The DoD OIG does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are resolved between the agencies.

1.J. Use of Estimates

The preparation of financial statements requires management to make certain estimates and assumptions that affect the reported amount of assets and liabilities, at the date of the financial statements, and the amount of revenues and costs reported during the period. Actual results could differ from those estimates.

1.K. General Property, Plant and Equipment

General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years, and when the acquisition cost equals or exceeds the DoD capitalization threshold of \$100,000. Also, improvement costs over the DoD

capitalization threshold of \$100,000 for General PP&E are required to be capitalized. All General PP&E is depreciated on a straight-line basis.

1.L. Advances and Prepayments

Payments in advance of the receipt of goods and services are recorded as advances or prepayments and reported as assets on the Balance Sheet. Advances and prepayments are recognized as expenditures and expenses when the related goods and services are received.

1. M. Leases

Generally, lease payments are for the rental of equipment and operating facilities and are classified as either capital or operating leases. When a lease is essentially equivalent to an installment purchase of property (a capital lease) and the value equals or exceeds the current DoD capitalization threshold, the applicable asset and liability are recorded. The amount recorded is the lesser of the present value of the rental and other lease payments during the lease term, excluding that portion of the payments representing executory costs paid to the lessor, or the asset's fair value. Leases that do not transfer substantially all of the benefits or risks of ownership are classified as operating leases and recorded as expenses as payments are made over the lease term.

1.N. Contingencies and Other Liabilities

The SFFAS No. 5, "Accounting for Liabilities of the Federal Government," defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss to the DoD OIG. The uncertainty will be resolved when one or more future events occur or fail to occur. A contingency is recognized as a liability when a past event or exchange transaction has occurred, a future loss is probable and the amount of loss can be reasonably estimated. Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility that a loss or additional loss will be incurred.

1.O. Accrued Leave

Civilian annual leave and military leave that have been accrued and not used as of the balance sheet date are reported as liabilities. The liability reported at the end of the fiscal year reflects the current pay rates.

1.P. Net Position

Net Position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations represent amounts of authority, which are unobligated and have not been rescinded or withdrawn, and amounts obligated but for which legal liabilities for payments have not been incurred.

Cumulative results of operations represent the balances that results from subtracting expenses and losses, from financing sources including appropriations, revenue, and gains since the inception of the activity

1.Q. Undelivered Orders

The DoD OIG records obligations for goods and services that have been ordered but not yet received. No liability for payment has been established in the financial statements because goods or services have yet to be delivered.

NOTE 2. NONENTITY ASSETS

As of September 30	2006	2005 (Unaudited)
1. Intragovernmental Assets		
A. Fund Balance with Treasury	\$ 0	\$ 0
B. Accounts Receivable	0	0
C. Total Intragovernmental Assets	\$ 0	\$ 0
2. Nonfederal Assets		
A. Cash and Other Monetary Assets	\$ 0	\$ 0
B. Accounts Receivable	0	0
C. Other Assets	0	0
D. Total Nonfederal Assets	\$ 0	\$ 0
3. Total Nonentity Assets	\$ 0	\$ 0
4. Total Entity Assets	\$ 42,606,668	\$ 35,971,167
5. Total Assets	\$ 42,606,668	\$ 35,971,167

Asset accounts are categorized either as entity or nonentity. Entity accounts consist of resources that the agency has the authority to use, or funds that management is legally obligated to use to meet entity obligations. Nonentity accounts are assets that are held by an entity, but are not available for use in the operations of the entity.

NOTE 3. FUND BALANCE WITH TREASURY

As of September 30	2006	2005 (Unaudited)
1. Fund Balances		
A. Appropriated Funds	\$ 42,303,166	\$ 35,610,108
B. Revolving Funds	0	0
C. Trust Funds	0	0
D. Special Funds	0	0
E. Other Fund Types	0	0
F. Total Fund Balances	<u>\$ 42,303,166</u>	<u>\$ 35,610,108</u>

Office of Inspector General (OIG) is a Department of Defense (DoD) agency using Treasury Index 97. The Department of Treasury (Treasury) reports fund balances at the appropriation basic symbol level. The DoD OIG funding is allotted at limit level.

STATUS OF FUND BALANCE WITH TREASURY

As of September 30	2006	2005 (Unaudited)
1. Unobligated Balance		
A. Available	\$ 7,488,427	\$ 3,532,708
B. Unavailable	8,094,961	1,804,694
2. Obligated Balance not yet Disbursed	\$ 26,757,937	\$ 30,284,618
3. Nonbudgetary FBWT	\$ 0	\$ 0
4. NonFBWT Budgetary Accounts	<u>\$ (38,159)</u>	<u>\$ (11,912)</u>
5. Total	<u>\$ 42,303,166</u>	<u>\$ 35,610,108</u>

The Department of Defense Office of the Inspector General did not have any suspense or budget clearing accounts to report at September 30, 2006.

NOTE 4. ACCOUNTS RECEIVABLES

As of September 30	2006			2005 (Unaudited)
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
1. Intra- governmental Receivables	\$ 203	N/A	\$ 203	\$ 0
2. Nonfederal Receivables (From the Public)	\$ 49,032	\$ 0	\$ 49,032	\$ 51,726
3. Total Accounts Receivable	\$ 49,235	\$ 0	\$ 49,235	\$ 51,726

The Department of Defense (DoD) policy is to allocate supported undistributed collections between federal and non-federal categories based on the percentage of federal and non-federal accounts receivable. The amount of unsupported undistributed collections are posted to the liability for deposit funds, clearing account and undeposited.

Other Information Related to Accounts Receivable

CATEGORY	Intragovernmental	Nonfederal
Nondelinquent	\$203	\$48,748
Current		
Noncurrent		
Delinquent		
1 to 30 days		\$156
31 to 60 days		\$128
61 to 90 days		
91 to 180 days		
181 days to 1 year		
Greater than 1 year and less than or equal to 2 years		
Greater than 2 years and less than or equal to 6 years		
Greater than 6 years and less than or equal to 10 years		
Greater than 10 years		
Subtotal		
Less Supported Undistributed Collections	0	0

Less Eliminations	0	0
Less Other	0	0
Total	\$203	\$49,032

NOTE 5. GENERAL PROPERTY, PLANT AND EQUIPMENT, NET

The General Property, Plant and Equipment at September 30, 2006 and 2005 follows:

As of September 30	2006					2005 (Unaudited)	
	Depreciat ion/ Amortizat ion Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value	Prior FY Net Book Value	
1. Major Asset Classes							
A. Land	N/A	N/A	\$ 0	N/A	\$ 0	\$	0
B. Buildings, Structures, and Facilities	S/L	20 Or 40	0	\$ 0	0		0
C. Leasehold Improvements	S/L	Lease Term	0	0	0		0
D. Software	S/L	2-5 Or 10	0	0	0		0
E. General Equipment	S/L	5 or 10	654,444	(654,444)	0		109,029
F. Military Equipment	S/L	Various	0	0	0		0
G. Assets Under Capital Lease	S/L	Lease Term	0	0	0		0
H. Construction-in-Progress	N/A	N/A	0	N/A	0		0
I. Other			0	0	0		0
J. Total General PP&E			\$ 654,444	\$ -654,444	\$ 0	\$	109,029

Legend for Valuation Methods:

S/L = Straight Line N/A = Not Applicable

NOTE 6. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

As of September 30	2006		2005 (Unaudited)	
1. Intragovernmental Liabilities				
A. Accounts Payable	\$	0	\$	0
B. Debt		0		0
C. Other		1,650,041		1,259,733
D. Total Intragovernmental Liabilities	\$	1,650,041	\$	1,259,733
2. Nonfederal Liabilities				
A. Accounts Payable	\$	0	\$	0

As of September 30	2006	2005 (Unaudited)
1. Intragovernmental Liabilities		
B. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities	6,399,249	5,011,404
C. Environmental Liabilities	0	0
D. Other Liabilities	11,052,444	10,062,712
E. Total Nonfederal Liabilities	\$ 17,451,693	\$ 15,074,116
3. Total Liabilities Not Covered by Budgetary Resources	\$ 19,101,734	\$ 16,333,849
4. Total Liabilities Covered by Budgetary Resources	\$ 8,906,398	\$ 6,340,532
5. Total Liabilities	\$ 28,008,132	\$ 22,674,381

Liabilities Not Covered by Budgetary Resources

Liabilities that are not considered covered by budgetary resources as of the Balance Sheet date. Budgetary resources encompass the following:

- New budget authority.
- Spending authority from offsetting collections (credited to an appropriation or fund account).
- Recoveries of unexpired budget authority through downward adjustments of prior-year obligations.
- Unobligated balances of budgetary resources at the beginning of the year or net transfers of prior-year balances during the year.
- Borrowing authority or permanent indefinite appropriations, which have been enacted and signed into law as of the balance sheet date, provided that the resources may be apportioned by the OMB without further action by the Congress or without a contingency first having to be met.

Liabilities Covered by Budgetary Resources

Resources incurred by the reporting entity which are covered by realized budget resources as of the balance sheet date. Budgetary resources encompass not only new budget authority, but also other resources available to cover liabilities for specified purposes in a given year. Available budgetary resources include the following:

- New budget authority.
- Spending authority from offsetting collections (credited to an appropriation or fund account).

- Recoveries of unexpired budget authority through downward adjustments of prior year obligations.
- Unobligated balances of budgetary resources at the beginning of the year or net transfers of prior-year balances during the year.

NOTE 7. ACCOUNTS PAYABLE

As of September 30	2006			2005 (Unaudited)
	Accounts Payable	Interest, Penalties, and Administrative Fees	Total	Total
1. Intragovernmental Payables	\$ 1,486,328	\$ N/A	\$ 1,486,328	\$ 0
2. Nonfederal Payables (to the Public)	1,484,490	0	1,484,490	687,919
3. Total	\$ 2,970,818	\$ 0	\$ 2,970,818	\$ 687,919

Intragovernmental accounts payable consists of amounts owed to other federal agencies for goods or services ordered and received but not yet paid. Interest, penalties and administrative fees are not applicable to intragovernmental payables. Non-federal payables (to the public) include payments to nonfederal government entities.

NOTE 8. OTHER LIABILITIES

As of September 30	2006			2005 (Unaudited)
	Current Liability	Noncurrent Liability	Total	Total
1. Intragovernmental				
A. Advances from Others	\$ 0	\$ 0	\$ 0	\$ 0
B. Deposit Funds and Suspense Account Liabilities	0	0	0	0
C. Disbursing Officer Cash	0	0	0	0

D. Judgment Fund Liabilities	0	0	0	0
E. FECA Reimbursement to the Department of Labor	0	1,650,041	1,650,041	1,259,733
F. Other Liabilities	884,922	0	884,922	836,747
G. Total Intragovernmental Other Liabilities	\$ 884,922	\$ 1,650,041	\$ 2,534,963	\$ 2,096,480
2. Nonfederal				
A. Accrued Funded Payroll and Benefits	\$ 4,576,219	\$ 0	\$ 4,576,219	\$ 4,332,849
B. Advances from Others	0	0	0	0
C. Deferred Credits	0	0	0	0
D. Deposit Funds and Suspense Accounts	0	0	0	0
E. Temporary Early Retirement Authority	0	0	0	0
F. Nonenvironmental Disposal Liabilities				
(1) Military Equipment (Nonnuclear)	0	0	0	0
(2) Excess/Obsolete Structures	0	0	0	0
(3) Conventional Munitions Disposal	0	0	0	0
G. Accrued Unfunded Annual Leave	11,052,444	0	11,052,444	10,062,712
H. Capital Lease Liability	0	0	0	0
I. Other Liabilities	474,439	0	474,439	483,017
J. Total Nonfederal Other Liabilities	\$ 16,103,102	\$ 0	\$ 16,103,102	\$ 14,878,578
3. Total Other Liabilities	\$ 16,988,024	\$ 1,650,041	\$ 18,638,065	\$ 16,975,058

NOTE 9. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT RELATED ACTUARIAL LIABILITIES

As of September 30	2006				2005 (Unaudited)
	Present Value of Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liability	Present Value of Benefits
1. Pension and Health Actuarial Benefits					
A. Military Retirement Pensions	\$ 0		\$ 0	\$ 0	\$ 0
B. Military Retirement Health Benefits	0		0	0	0
C. Military Medicare-Eligible Retiree Benefits	0		0	0	0
D. Total Pension and Health Actuarial Benefits	\$ 0		\$ 0	\$ 0	\$ 0
2. Other Actuarial Benefits					
A. FECA	\$ 6,399,249		\$ 0	\$ 6,399,249	\$ 5,011,404
B. Voluntary Separation Incentive Programs	0		0	0	0
C. DoD Education Benefits Fund	0		0	0	0
D. Total Other Actuarial Benefits	\$ 6,399,249		\$ 0	\$ 6,399,249	\$ 5,011,404
3. Other Federal Employment Benefits	\$ 0		\$ 0	\$ 0	\$ 0
4. Total Military Retirement and Other Federal Employment Benefits:	\$ 6,399,249		\$ 0	\$ 6,399,249	\$ 5,011,404

Federal Employees Compensation Act (FECA)

The actuarial liability for workers' compensation benefits is developed by the Department of Labor and provided to the DoD OIG at the end of each fiscal year. The liability includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. The liability is determined by using historical benefit payment patterns to predict the future payments. Cost-of-living adjustments and medical inflation factors are also

included in the calculation of projected future benefits. Consistent with past practices, these projected annual benefit payments are then discounted to present value using the Office of Management and Budget's economic assumptions for 10-year Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

Year 1	5.170%
Year 2 and thereafter	5.313%

To provide more specificity for the effects of inflation on the liability for future workers' compensation benefits, wage inflation factors (cost-of-living adjustments or COLAs) and medical inflation factors (consumer price index-medical, or CPIMs) were applied to the calculation of projected future benefits. These factors were also used in adjusting the methodology's historical payments to current year constant dollars.

The compensation COLAs and CPIMs used in the projections for various charge back years (CBY) were as follows:

<u>CBY</u>	<u>COLA</u>	<u>CPIM</u>
2006	3.50%	4.00%
2007	3.13%	4.01%
2008	2.40%	4.01%
2009	2.40%	4.013%
2010+	2.43%	4.09%

The model's resulting projections were critically analyzed to insure that the estimates were reliable. The analysis was primarily based on two tests: (1) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments, and (2) a comparison of the ratio of the estimated liability to the actual payment of the beginning year, as calculated for the current projection to the liability-payment ratio calculated for the prior projection.

NOTE 10. GENERAL DISCLOSURES RELATED TO THE STATEMENT OF NET COST

Intragovernmental Costs and Exchange Revenue				
As of September 30	2006		2005 (Unaudited)	
1. Intragovernmental Costs	\$	48,312,222	\$	45,179,254
2. Public Costs		173,481,081		158,595,946
3. Total Costs	\$	221,793,303	\$	203,775,200
4. Intragovernmental Earned Revenue	\$	0.00	\$	(3,084,065)
5. Public Earned Revenue		39,535		0
6. Total Earned Revenue	\$	39,535	\$	(3,084,065)
7. Net Cost of Operations	\$	221,832,838	\$	200,691,135

Disclosures Related to the Statement of Net Cost

The Consolidated Statement of Net Cost (SNC) in the federal government is unique because its principles are driven on understanding the net cost of programs and/or organizations that the federal government supports through appropriations or other means. This statement provides gross and net cost information that can be related to the amount of output or outcome for a given program and/or organization administered by a responsible reporting entity.

NOTE 11. DISCLOSURES RELATED TO THE STATEMENTS OF CHANGES IN NET POSITION (IN THOUSANDS)

As of September 30	2006		2005 (Unaudited)	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Prior Period Adjustments Increases (Decreases) to Net Position Beginning Balance				
A. Changes in Accounting Standards	\$ 0	\$ 0	\$ 0	\$ 0

B. Errors and Omissions in Prior Year Accounting Reports	0	0	0	0
C. Total Prior Period Adjustments	\$ 0	\$ 0	\$ 0	\$ 0
2. Imputed Financing				
A. Civilian CSRS/FERS Retirement	\$ 4,481,223	\$ 0	\$ 4,675,697	\$ 0
B. Civilian Health	6,259,113	0	5,640,901	0
C. Civilian Life Insurance	21,940	0	20,065	0
D. Judgment Fund	0	0	0	0
E. IntraEntity	0	0	0	0
F. Total Imputed Financing	\$ 10,762,276	\$ 0	\$ 10,336,663	\$ 0

Other Information:Information Related to the Statement of Changes in Net Position

The financial statements and accompanying notes report on the financial position and results of operations, as of the 4th Quarter, FY 2006, for the Office of the Inspector General of the Department of Defense.

Imputed Financing

The amounts remitted to the Office of Personnel Management (OPM) by and for employees covered by the Civil Service Retirement System (CSRS), Federal Employee Retirement System (FERS), Federal Employees Health Benefits Program (FEHB) and the Federal Employee Group Life Insurance Program (FEGLI) do not fully cover the Government's cost to provide these benefits. An imputed cost is recognized as the difference between the Government's cost of providing these benefits and employee contributions made by and for them. The OPM provides the cost factors to the Defense Finance and Accounting Service (DFAS) for computing imputed financing costs. The DFAS provides computed costs to the Office of the Under Secretary of Defense (Personnel and Readiness) (OUSD(P&R)) for validation and approval. The official imputed costs are then provided to the reporting components for inclusion in their financial statements.

NOTE 12. DISCLOSURES RELATED TO THE STATEMENT OF BUDGETARY RESOURCES

As of September 30	2006	2005
1. Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	\$ 18,105,806	\$ 24,144,391
2. Available Borrowing and Contract Authority at the End of the Period	0	0

Apportionment Categories

(Amount in thousands)	
<u>Direct Obligations</u>	
Category A	\$215,676
Category B	<u>0</u>
Total Direct Obligations	\$215,676
Exempt from Apportionment	\$0
Reimbursable Obligations	<u>\$208</u>
Total Obligations	<u>\$215,884</u>

Information Related to the Statement of Budgetary Resources

Undelivered Orders presented in the Statement of Budgetary Resources (SBR) include Undelivered Orders-Unpaid for both direct and reimbursable funds.

Adjustments to funds that are temporarily not available pursuant to Public Law and adjustments to funds that are permanently not available (included in the Adjustments line on the SBR) are not included in the Spending Authority from Offsetting Collections and Adjustments line on the SBR nor on the Spending Authority for Offsetting Collections and Adjustments line on the Statement of Financing.

NOTE 13. DISCLOSURES RELATED TO THE STATEMENT OF FINANCING

Components of the Net Cost of Operations that will not Require or Generate Resources in Future Period:

The objective of the Statement of Financing is to reconcile the difference between budgetary obligations and the net cost of operations reported. The Office of Management and Budget Circular A-136 requires the Statement of Financing to be presented on a consolidated basis.

The following Statement of Financing lines are presented as combined instead of consolidated due to interagency budgetary transactions not being eliminated:

- Obligations Incurred
- Less: Spending Authority from Offsetting Collections and Recoveries
- Obligations Net of Offsetting Collections and Recoveries
- Less: Offsetting Receipts
- Net Obligations
- Undelivered Orders
- Unfilled Customer Orders

The Other line in Resources Used to Finance Activities consists of other gains and losses.

The Other line in Resources Used to Finance Items not Part of the Net Cost of Operations consists of other gains and losses.

The Other line in Components Requiring or Generating Resources in Future Period section consists of future funded expenses for unfunded leave.

The Other line in Components of the Net Cost of Operation that will not Require or Generate Resources in the Current Period consists of cost capitalization offset.

NOTE 14. LEASES

As of September 30	2006 Asset Category			
	Land and Buildings	Equipment	Other	Total

1. ENTITY AS LESSEE- Operating Leases

Future Payments Due

Fiscal Year

2007	\$	8,668,769	\$	0	\$	0	\$	8,668,769
2008		4,567,309		0		0		4,567,309
2009		3,845,859		0		0		3,845,859
2010		2,959,330		0		0		2,959,330
2011		2,081,216		0		0		2,081,216
After 5 Years								
		4,134,205		0		0		4,134,205

Total Future Lease Payments Due

\$	26,256,688	\$	0	\$	0	\$	26,256,688
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Other Information – According to the FMR Volume 6B, Chapter 10, the Inspector General must disclose information relating to operating leases such as the existence and terms of renewal options, escalation clauses, restrictions imposed by lease agreements, contingent rental and the lease period. We projected fiscal years FY05-FY09 and five years after. Our calculations were based on current expiration of lease agreements shown in the GSA website.

Office buildings in the amount of \$26.3 million represent office space rental. The lease periods are from three to ten years. There are no escalation clauses or contingent rental restrictions.

Appendix A – DoD OIG Management’s Comments On the Auditors’ Report



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

November 6, 2006

MEMORANDUM FOR ACUITY CONSULTING, INC

SUBJECT: Draft Report of the Office of the Inspector General, Department of Defense
FY 2006 Financial Statement Audit.

The Office of the Inspector General, Department of Defense is providing the attached general comments to the material weaknesses identified during the FY 2006 Financial Statement audit.

The point of contact is Mr. Marlon Moreira. Mr. Moreira can be reached at (703) 602-2226.


Diane M. Randon
Comptroller

Attachment:
As stated

Auditor's Comment:

1.) The DoD OIG does not perform adequate managerial review of the information processed by DFAS.

We observed that DoD OIG has many activities that replicate the actions taken by their service provider. In some cases the activities are more akin to converting data from one format to another (i.e. PDF to Excel). However, business processes do not exist to independently validate the information being processed by the service provider. Consequently, the analysis of the information at the financial reporting level is not adequately performed.

Management Comments:

The DoD OIG concurs with this comment. However, many of DFAS's reports are in formats that are not user friendly (TXT, PDF). In order to properly review the information, we need to convert this information to perform our own analysis and independently verify the accuracy of the information. The DoD OIG has several managerial reviews that are not fully documented. The OIG will work with the key personnel to formally document these processes and also implement an adequate independent validation process to improve our current analysis of information at the financial reporting level.

Auditor's Comment:

2.) The DoD OIG does not have a process in place to ensure the completeness of the quarterly or year-end financial statements.

Our analysis of the financial statements identified that DoD OIG does not have a business process in place to identify, estimate, record and validate the adequacy of accruals at each reporting period. The DoD OIG developed accruals for the first time for the September 30, 2006 financial statements. The only accrual data that was included in their financial statements previously was for payroll and other Department level data, rather than for the DoD OIG's operational transactions. Additionally, the DoD OIG in conjunction with their service provider have not fully documented the crosswalks used to develop the DD 1176 from the WAAS general ledger. This report serves as an integral piece of the audit trail from the general ledger to the Statement of Budgetary Resources. Using alternative procedures we were able to validate the statement.

Management Comments:

The DoD OIG concurs with this comment. The current process in place does not adequately ensure the completeness of the quarterly or year-end financial statements. We

will initiate a process to properly reconcile and validate the DD 1176 report produced by DFAS. At this moment, the only reconciliation process that we have is an Access database that matches the WHS WAAS trial balance. The DoD OIG will work with DFAS Indianapolis to develop an Access database process to fully account for every entry reported in our DD 1176. The DoD OIG will also work with DFAS Indianapolis to refine our accrual process to properly reflect the accrual portion that must be recorded at the end of each quarter and also at year-end.

Auditor's Comment:

3.) The DoD OIG does not have fundamental processes in place to ensure that transactions initiated are appropriately reviewed and approved.

We observed that the DoD OIG does not have business practices in place to perform adequate management review of transactions recorded to their books. For example, there are no business processes to review the validity of lease or facilities costs recorded nor is there a process to validate the amounts recorded for personnel benefits costs. The DoD OIG did not realize that management reviews and validation processing controls were essential to fulfill their management stewardship responsibilities.

Management Comments:

The DoD OIG concurs in principle with this comment. The DoD OIG **does not have a written** process to reflect the adequacy of the reviews that validate the transactions recorded in its books, but it **does** have processes in place to review the adequacy of the recorded amounts. The Office of the Comptroller works together with the Audited Financial Statements department at DFAS Indianapolis during the quarter and/or year end reporting period to properly coordinate the initiation and approval of critical transactions that may affect the DoD OIG's Financial Statements. The DoD OIG **does** realize that reviews and validating processing controls are essential to properly safeguard the assets entrusted to the OIG and to properly ensure that transactions are appropriately reviewed and approved.

We do agree that these conditions create vulnerability for material misstatement, lack of reliability and completeness of the DoD OIG's financial statements. We will take the necessary steps to correct these deficiencies by meeting with the directors at DoD OIG headquarters and at DFAS Indianapolis to streamline processes to accurately capture the necessary information to support the reported amounts.