

A *udit*



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INSPECTOR GENERAL, DOD, OVERSIGHT
OF THE ARMY AUDIT AGENCY AUDIT
OF THE FY 2000 ARMY GENERAL FUND
FINANCIAL STATEMENTS

Report No. D-2001-064

February 28, 2001

Office of the Inspector General
Department of Defense

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Arlington, VA 22202-4704

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Acronym

AAA

Army Audit Agency



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**

February 28, 2001

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE**

SUBJECT: Audit Report on Inspector General, DoD, Oversight of the Army Audit Agency Audit of the FY 2000 Army General Fund Financial Statements (Report No. D-2001-064)

We are providing this audit report for your information and use and for transmittal to the Director, Office of Management and Budget. It includes our endorsement of the Army Audit Agency disclaimer of opinion on the FY 2000 Department of the Army General Fund financial statements, along with excerpts from the Army Audit Agency report, "Army's General Fund Principal Financial Statements for Fiscal Year 2000: Summary Audit Report," February 7, 2001. An audit of the Department of the Army General Fund financial statements is required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. Because this report contains no findings or recommendations, written comments are not required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Richard B. Bird at (703) 604-9159 (DSN 664-9159) (rbird@dodig.osd.mil) or Mr. Jack L. Armstrong at (317) 510-3846 (DSN 699-3846) (jarmstrong@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Acting Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2001-064

(Project No. D2001FI-0036.000)

February 28, 2001

Inspector General, DoD, Oversight of the Army Audit Agency Audit of the FY 2000 Army General Fund Principal Financial Statements

Executive Summary

Introduction. Public Law 101-576, the “Chief Financial Officers Act of 1990,” November 15, 1990, as amended by Public Law 103-356, the “Federal Financial Management Act of 1994,” October 13, 1994, requires DoD to prepare annual audited Army General Fund financial statements. Office of Management and Budget Bulletin No. 01-02, “Audit Requirements for Federal Financial Statements,” October 16, 2000, establishes the minimum requirements for audits of these financial statements. This Bulletin requires the Inspector General, DoD, to express an opinion on the DoD financial statements and to report on the adequacy of internal controls and compliance with laws and regulations. We delegated the audit of the FY 2000 Department of the Army General Fund financial statements to the Army Audit Agency. This report is the first in a series of reports and discusses the work performed on the oversight of the Army Audit Agency audit.

Objectives. Our audit included two overall objectives. The first objective was to oversee the Army Audit Agency audit to verify whether we can rely on the work done by the Army Audit Agency. This report focuses on the oversight objective. Specifically, we:

- reviewed the Army Audit Agency approach and planning for the audit,
- monitored the progress of the audit at key points,
- reviewed audit reports before the Army Audit Agency issued them, and
- performed other procedures necessary to evaluate the adequacy of the audit approach and conclusions.

The second objective, to determine whether the Defense Finance and Accounting Service Indianapolis consistently and accurately compiled financial data from field activities and other sources for the FY 2000 Army General Fund financial statements, will be addressed in a separate report. See Appendix A for a discussion of the audit process.

Results. The Army Audit Agency could not express an opinion on the FY 2000 Department of the Army General Fund financial statements. We concur with the Army Audit Agency disclaimer of opinion; our endorsement of that disclaimer is Exhibit 1. Excerpts of the Army Audit Agency report are included as Exhibit 2 and provide the reasons for the disclaimer of opinion and identify the material weaknesses and reportable conditions associated with the internal controls and compliance with laws and regulations. The complete Army Audit Agency audit report, "Army's General Fund Principal Financial Statements for Fiscal Year 2000: Summary Audit Report," February 7, 2001, can be accessed on the Internet at <http://www.aaa.army.mil>. Fiscal Year 2000 Army General Fund Financial Statements can be accessed on the Internet at www.dtic.mil/comptroller.

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Appendix A. Audit Process

Scope and Methodology

Audit Work Performed. To fulfill our responsibilities under Public Law 101-576, the “Chief Financial Officers Act of 1990,” November 15, 1990, as amended by Public Law 103-356, the “Federal Financial Management Act of 1994,” October 13, 1994, and Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," dated October 16, 2000, we performed oversight of the independent audit conducted by the Army Audit Agency (AAA) of the FY 2000 Army General Fund financial statements. We reviewed the AAA audit approach and planning and monitored audit progress at key points.

Reviewing the AAA Audit Approach. We used the “Federal Financial Statements Audit Manual,” January 1993, issued by the President’s Council on Integrity and Efficiency, and the “Financial Audit Manual,” December 12, 1997, issued by the General Accounting Office, as the criteria for reviewing the AAA audit approach. Specifically, we reviewed the engagement letter, participated in the entrance conference, assisted in formulating the audit strategy, and commented on audit plans and programs. We also participated in audit planning and working group meetings coordinated by the Inspector General, DoD, and the AAA.

Monitoring Audit Progress. Through the DoD Financial Statement Audit Executive Steering Committee, and an integrated line-item oversight effort, we provided a forum for a centrally managed exchange of guidance and information. We attended In-Process Review workshops, where AAA discussed the results of audit work they performed for the DoD line item managers. For example, we attended the workshop where AAA detailed the work completed on additions and deletions of National Defense Property, Plant, and Equipment on the property books. We participated in audit working groups on significant topics in financial reporting for the Army General Fund. For example, we participated in the audit working group for the review of field accounting site compilation, and the working group for real property. We reviewed and commented on related draft audit reports issued by the AAA, including the opinion report and the report on internal controls and compliance with laws and regulations.

In addition to these oversight procedures, we performed other procedures as necessary to determine the fairness and accuracy of the AAA audit approach and conclusions. We co-performed audit work with the AAA on the review of accounting information compiled and reported by field accounting sites, and the compilation of the Army General Fund financial statements at the Defense Finance and Accounting Service Indianapolis. We also used the results of the line item managers’ and General Accounting Office reviews of AAA audit work to increase our understanding and provide meaningful input to the AAA. For example, the line item manager for National Defense Property, Plant, and Equipment co-performed audit work with AAA on the reporting of Required Supplemental Stewardship Information.

DoD-Wide Corporate-Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate-level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goal, and performance measures.

FY 2001 DoD Corporate-Level Goal 2: Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-02)**

FY 2001 Subordinate Performance Goal 2.5: Improve DoD financial and information management. **(01-DoD-2.5)**

FY 2001 Performance Measure 2.5.1: Reduce the number of noncompliant accounting and finance systems. **(01-DoD-2.5.1).**

FY 2001 Performance Measure 2.5.2: Achieve unqualified opinions on financial statements. **(01-DoD-2.5.2.).**

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

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

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

Audit Type, Period, and Standards. We performed this financial statement audit from October 12, 2000, to February 7, 2001, in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We did not use computer-processed data or statistical sampling procedures to conduct our oversight of the AAA audit of the FY 2000 Department of the Army General Fund financial statements.

Contacts During the Audit. We visited or contacted individuals and organizations in the DoD audit and accounting communities. Further details are available upon request.

Prior Coverage

The General Accounting Office and the Inspector General, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. Inspector General, DoD, reports can be accessed on the Internet at <https://www.dodig.osd.mil>.

Appendix B. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

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

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

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

Other Defense Organization

Director, Defense Finance and Accounting Service

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

**Exhibit 1. Inspector General, DoD,
Endorsement Memorandum**



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**

February 7, 2001

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE**

SUBJECT: Endorsement of the Disclaimer of Opinion on the FY 2000 Army General Fund Financial Statements (Project No. D2000FI-0063.000)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General. We delegated to the Army Audit Agency (AAA) the audit of the FY 2000 Army General Fund financial statements. Summarized as follows are the AAA disclaimer of opinion on the FY 2000 Army General Fund financial statements and the results of our review of the AAA audit. The information provided in this memorandum contains reasons for the AAA disclaimer. We endorse the disclaimer of opinion expressed by AAA.

Disclaimer of Opinion. The AAA disclaimer of opinion on the FY 2000 Army General Fund financial statements, dated February 7, 2001, states that AAA was unable to express an opinion on the financial statements. We concur with the AAA disclaimer of opinion for the reasons summarized as follows.

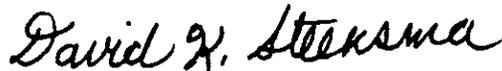
AAA could not express an opinion on the financial statements primarily because of continual problems with inadequate accounting systems, insufficient audit trails, and procedural problems. The problems prevented AAA from using any practical methods to conduct audit work of sufficient scope to express an opinion on the FY 2000 Army General Fund financial statements. Also, the financial statements were not prepared in time for AAA to perform necessary audit work prior to reporting deadlines established by the Office of Management and Budget. Inadequate accounting systems required the Defense Finance and Accounting Service Indianapolis to make unsupported adjustments to force the general ledger to match status-of-funds data. For FY 2000, \$237 billion of unsupported adjustments were made to force the general ledger to match status-of-funds data.

Internal Controls. The AAA tested internal controls but did not express a separate opinion because opining on internal controls was not one of its objectives. However, AAA determined that internal controls did not provide reasonable assurance of achieving the internal control objectives described in Office of Management and Budget Bulletin 01-02, "Audit Requirements for Federal Financial Statements," dated October 16, 2000. For example, the Army General Fund did not have effective internal controls over about \$14.2 billion in inventory. The Army and the Defense Finance and Accounting Service recognized many financial reporting weaknesses and reported them in their FY 2000 Annual Statements of Assurance. Details on the internal control weaknesses will be provided in separate AAA reports.

Compliance With Laws and Regulations. The AAA determined that the Army still is unable to fully comply with laws and regulations related to the Army financial statements. The systems that support the Army financial statements did not meet the requirements of the Federal Financial Management Improvement Act of 1996. Specifically, these systems did not substantially comply with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. For example, financial management systems did not maintain audit trails, which is a Federal financial management system requirement. Also, the Army is not yet able to fully comply with the Chief Financial Officers Act of 1990 and related requirements. Although the Army and the Defense Finance and Accounting Service have made a concerted effort to meet the requirements of the Act, current management and accounting systems were not designed for financial statement reporting and they can not produce reliable and auditable financial statements.

Review of Army Audit Agency Work. To fulfill our responsibilities for determining the accuracy and completeness of the independent audit work that AAA conducted, we reviewed the audit approach and planning and monitored progress at key points. We also performed other procedures to determine the fairness and accuracy of the approach and conclusions. For example, we independently assessed the accuracy of the FY 2000 accrued unfunded annual leave expense applicable to military personnel within the Army.

We reviewed the AAA work on the FY 2000 Army General Fund financial statements from January 7, 2000, through February 7, 2001, in accordance with generally accepted Government auditing standards. We found no indication that we could not rely on the AAA disclaimer of opinion or its related evaluation of internal controls and compliance with laws and regulations.



David K. Steensma
Deputy Assistant Inspector General
for Auditing

**Exhibit 2. Excerpts from the Army
Audit Agency Audit Report,
“Army’s Principal Financial
Statements for FY 2000:
Summary Audit Report”**

**Army's General Fund
Principal Financial
Statements for
Fiscal Year 2000**

Summary Audit Report

**7 February 2001
Audit Report: AA 01-170**



U.S. Army Audit Agency





DEPARTMENT OF THE ARMY
U.S. ARMY AUDIT AGENCY
Office of The Auditor General
3101 Park Center Drive
Alexandria, VA 22302-1596

7 February 2001

Acting Secretary of the Army

This report summarizes the results of our efforts to audit the Army's General Fund Principal Financial Statements for the fiscal year ended 30 September 2000. We performed our work pursuant to the Chief Financial Officers Act of 1990 as amended by the Government Management Reform Act of 1994.

We could not express an opinion on the financial statements primarily because of inadequate accounting systems and incomplete or unauditible supporting records. We were unable to apply other reasonable auditing procedures to satisfy ourselves as to the fairness of the data presented.

This report doesn't contain recommendations, but it does include brief discussions of our results and conclusions. More detailed discussions of our results and conclusions, as well as recommendations, are in various supporting audit reports (see Annex C).

I appreciate the courtesies and cooperation extended to us during the audit.

FRANCIS E. REARDON, CPA
The Auditor General

For more information about this audit, please call the General Fund Audits Division at (703) 681-9766. For extra copies of this report, please call (703) 681-9863.

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Note: The financial statements and notes at Annex A are the latest version as of the date of this report. These notes still contain comparative data that should not be included in the final statements and notes that the Army will publish in its Annual Financial Report.

BACKGROUND

BACKGROUND

Annual Financial Statements

Federal agencies are required to submit a set of financial statements, overview and notes that were standardized by Office of Management and Budget Bulletin 97-01. The Army is required to prepare these general fund financial statements:

- Balance Sheet.
- Statement of Net Cost.
- Statement of Changes in Net Position.
- Statement of Budgetary Resources.
- Statement of Financing.

In addition, the Army must report Required Supplemental Stewardship Information. The major component of this is National Defense Property, Plant and Equipment, which is composed of weapon systems plus the support property, plant, and equipment used in the performance of military missions.

Accounting Services

The Defense Finance and Accounting Service has a primary role in the Army's financial operations. It performs much of the Army's accounting services and prepares the Army's annual financial statements. The Accounting Service—subordinate to the Under Secretary of Defense (Comptroller)—owns and operates most of the financial accounting and reporting systems used to account for the Army's resources. The logistics community manages various non-financial feeder systems that provide much of the financial data to these accounting and reporting systems. Since its establishment in 1991, the Accounting Service has capitalized most of the Army's accounting offices. All offices that account for Army resources report accounting data to the Defense Finance and Accounting Service-Indianapolis, which uses the data to prepare summary financial reports. Additional information about the financial systems and the associated reporting structure is in the Overview portion of the Army's Annual Financial Report.

BACKGROUND

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Audit Services

For the Army's FY 00 financial statements, the Inspector General, DOD delegated audit responsibility to the U.S. Army Audit Agency. The Inspector General, DOD assisted us by performing required audit work at the Defense Finance and Accounting Service-Indianapolis. This work consisted of examining the processes that the Accounting Service used to compile and summarize accounting data and to prepare the Army's financial statements. The financial statements are to be audited in accordance with Generally Accepted Government Auditing Standards and Office of Management and Budget Bulletin 01-02 (Audit Requirements for Federal Financial Statements).

Generally Accepted Accounting Principles

The American Institute of Certified Public Accountants' Statement on Auditing Standards No. 91 describes the hierarchy of accounting principles for federal governmental entities as follows:

Established Accounting Principles

- Category (a): Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations plus American Institute of Certified Public Accountants (AICPA) and Financial Accounting Standards Board (FASB) pronouncements if made applicable to federal governmental entities by a FASAB Statement or Interpretation.
- Category (b): FASAB Technical Bulletins and the following pronouncements if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.
- Category (c): AICPA Accounting Standards Executive Committee Practice Bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB.
- Category (d): Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government.

Other Accounting Literature

- Other accounting literature—including FASAB Concepts Statements, pronouncements in categories (a) through (d) when not specifically made applicable to federal governmental entities, and FASB Concepts Statements.

According to Office of Management and Budget Bulletin 01-02:

"Generally accepted accounting principles" (GAAP) for Federal government entities are identified in Statement on Auditing Standards (SAS) No. 91, *Federal GAAP Hierarchy*, Amendment to SAS 69, *The Meaning of Present Fairly In Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, which is codified in AU Sections 411.11-411.16 of the AICPA's Codification of Statements on Auditing Standards. Federal financial statements shall be prepared in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," and subsequent OMB issuances. The requirements of OMB's Form and Content Bulletin are generally accepted accounting principles because they constitute "practices that are widely recognized and prevalent in the federal government" under category (d) of the *Federal GAAP Hierarchy*.

Internal Controls

Internal control, as it relates to the Principal Statements and Required Supplementary Stewardship Information, is a process, effected by the organization's management and other personnel, designed to provide reasonable assurance that the following objectives are met:

- Reliability of financial reporting. Transactions are properly recorded, processed, and summarized to permit the preparation of the Principal Statements and Required Supplementary Stewardship Information in accordance with Federal accounting standards, and the safeguarding of assets against loss from unauthorized acquisition, use, or disposition.
- Compliance with applicable laws and regulations. Transactions are executed in accordance with: (a) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the Principal Statements or Required Supplementary Stewardship Information, and (b) any other laws, regulations, and government-wide policies identified by the Office of Management and Budget.

- Reliability of performance reporting. Transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.

AUDITOR'S REPORT



DEPARTMENT OF THE ARMY
U.S. ARMY AUDIT AGENCY
Office of the Auditor General
3101 Park Center Drive
Alexandria, VA 22302-1596

7 February 2001

Acting Secretary of the Army

As required by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994, the U.S. Army prepared the accompanying General Fund financial statements for fiscal year 2000. As delegated by, and in coordination with, the Inspector General, DOD, we were engaged to audit these statements. Our responsibility is limited to auditing these statements. The financial statements are the responsibility of Army management.

We were unable to express an opinion on these financial statements because inadequate accounting systems, insufficient audit trails, and procedural problems prevented us from using any practical methods to conduct audit work of sufficient scope to support an opinion. Also, we didn't receive the official statements as of the date of this report. Therefore, we caution users that the information presented in the financial statements may not be reliable.

Internal controls weren't sufficient to ensure that the financial statements contained no material misstatements. The Army and the Defense Finance and Accounting Service have recognized many financial reporting weaknesses and included them in their FY 00 annual assurance statements.

The Army isn't yet able to fully comply with laws and regulations that directly affect the financial statements. The primary noncompliance issue relates to the Chief Financial Officers Act of 1990 and related provisions that require the preparation of auditable financial statements. In addition, the systems that support the Army's financial statements didn't meet the requirements of the Federal Financial Management Improvement Act of 1996. Specifically, these systems didn't substantially comply with established Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. However, our limited audit work didn't identify any material instances of noncompliance that had not been previously reported.

We also performed a limited review of the information in the Overview section of the report and concluded that the financial data in that section

may not be reliable since it was derived from the same sources as the financial statements.

The Required Supplementary Stewardship Information (including national defense property, plant, and equipment; heritage assets; and stewardship land) is not a required part of the basic financial statements, and we did not audit and do not express an opinion on this information. However, we applied limited audit procedures prescribed by professional standards to the stewardship information and found some problems with the process and procedures used by the Army to capture and report this information

The supplementary information for deferred maintenance is not a required part of the basic financial statements, and we did not audit and do not express an opinion on this information. We didn't apply procedures prescribed by professional standards because the official accounting guidance regarding the measurement criteria and reporting placement of deferred maintenance on the financial statements was not fully developed.

Except for the limitations described above, we performed our work in accordance with generally accepted government auditing standards and Office of Management and Budget Bulletin 01-02 (Audit Requirements for Federal Financial Statements).


FRANCIS E. REARDON, CPA
The Auditor General

REPORT ON INTERNAL CONTROLS

REPORT ON INTERNAL CONTROLS

Internal controls didn't provide reasonable assurance that the financial statements didn't contain material misstatements. The Army and the Defense Finance and Accounting Service have recognized many material weaknesses and reported them in their FY 00 annual assurance statements on internal management controls. (We discuss this issue in the Report on Compliance with Laws and Regulations beginning on page 35.)

We evaluated and tested relevant financial internal controls related to the reporting of budgetary resources, material asset and liability balances, and the compilation process for financial statements at the Defense Finance and Accounting Service Indianapolis. We also selectively followed up on internal control deficiencies that we previously reported. Because of accounting system deficiencies, we didn't attempt to audit the expenses reported in the Army's statements.

We noted progress in several areas to correct previously identified problems. However, we also identified additional internal control problems. We consider all these problems reportable conditions under standards established by the American Institute of Certified Public Accountants and Office of Management and Budget Bulletin 01-02 (Audit Requirements for Federal Financial Statements). Reportable conditions represent significant deficiencies in the design or operation of the internal control structure. Material weaknesses are reportable conditions involving deficiencies in the design or operation of internal controls leading to an unacceptable high risk that losses, noncompliance or material misstatements in the financial statements could occur and not be detected promptly.

The Army has recognized that significant problems exist with the processes, procedures, and accounting systems used to prepare its financial statements. To address these problems, the Deputy Assistant Secretary of the Army for Financial Operations, in conjunction with functional experts within and outside the Army, has prepared a detailed plan called, "The Army Chief Financial Officers Strategic Plan." The Army is actively using this plan as a key management tool to improve its financial reporting, and it regularly reviews and updates the plan. As stated in the overview of the Annual Financial Report, the Army completed 54 of the separate tasks in the plan during FY 00, but we haven't verified the completion of these tasks. The Strategic Plan is updated quarterly, and it now covers the Working Capital Fund as well as the General Fund. The stated vision is that completing all the tasks will enable the Army to prepare auditable financial statements by FY 03.

However, this vision may not be achievable since some of the tasks now have projected completion dates beyond FY 03.

In this report on internal controls, we summarize the Army's FY 00 financial statement reporting problems in three sections:

- Systems and Procedures.
- Financial Accounts.
- Property Accounts.

Additional information is in our separate supporting reports listed in Annex C.

SYSTEMS AND PROCEDURES

In this section we discuss:

- Accounting systems.
- Other systems.
- Compilation process for financial statements.
- Subordinate activity adjustments.
- Performance information.

Accounting Systems

Deficiencies in the accounting and finance systems that account for Army resources constitute the major reason for our inability to render an audit opinion on the Army's financial statements. The accounting systems lack a single standard transaction-driven general ledger—an essential element of control for sound, reliable financial reporting. In addition, the accounting systems don't produce account-oriented transaction files (subsidiary ledgers), and data for physical assets is compiled using "work-around" procedures and data from management systems not intended and not suitable for financial reporting. Consequently, the audit trails necessary to verify and reconcile account

balances aren't adequate, and the statement balances aren't auditable by any practical means.

Because of system deficiencies, the Army uses a consolidation of accounting data from source documents, budgetary accounting systems, and multiple field-level and department-level entries to produce the financial statements. Army management couldn't provide reasonable assurance that the accounting and non-accounting systems used to record and report Army financial data were reliable. It also acknowledged the possible existence of material transactions that weren't properly recorded in the accounting records and included in the financial statements.

The Defense Finance and Accounting Service, as functional proponent for the Army's accounting and financial management systems, has reported inadequate general ledger control as a material weakness in its annual statement of assurance since FY 91. The FY 00 statement of assurance cites FY 03 as the estimated target date for correction.

The Accounting Service is working on a new accounting system—the Defense Joint Accounting System—that it believes will resolve many of the problems with existing systems. During FY 99 the Accounting Service conducted a test of the initial prototype at the Ballistic Missile Defense Organization. During the test we identified two weaknesses—the assignment of obligation numbers and the ability of travel clerks to potentially modify approved data. In the current DOD Financial Management Improvement Plan, the Accounting Service reported that the accounting system is not compliant with applicable requirements (including the Federal Financial Management Improvement Act) and will not achieve full operational capability until July 2005. Additionally, the latest deployment schedule shows that complete Army fielding will slip to March 2007. The Army may not have auditable financial statements until it has fielded an adequate accounting system.

Other Systems

The Army also needs to upgrade or replace many of its other systems that feed data to the accounting system so that the requirements of financial statement reporting can be met. The Army has recognized this problem and has included numerous system improvements in its strategic plan. Including these other system requirements in the strategic plan should enable Army management to coordinate and direct the needed progress in other automated systems.

Currently, the Army has identified 21 critical feeder systems. Here is the status of those systems.

Status	Description	Number of Systems
Compliant	System managers reported the system as compliant.	2
Not Compliant	System managers reported the system as not compliant.	1
Not Determined	The status of the system has not been determined.	3
Legacy System	The system's functions are to be consolidated into another system.	15
Total		21

The Army is still in the process of identifying all critical feeder systems and ensuring that each system is either compliant with the financial requirements or that it will be replaced by another system that is compliant. However, the Army doesn't have complete control over this effort because DOD owns some of these systems.

Compilation Process for Financial Statements

The Inspector General, DOD found several problems with the Defense Finance and Accounting Service's compilation of financial data from field entities and other sources. The most significant problems involved unsupported accounting entries. The magnitude of these entries meant that the FY 00 Army General Fund financial statements were materially influenced by unsupported accounting data. As a result, there is no assurance that the data in the financial statements is reliable.

The Defense Finance and Accounting Service-Indianapolis processed 458 accounting entries valued at \$451.6 billion while compiling the FY 00 Army General Fund financial statements. The value of unsupported entries increased from about \$290.2 billion in FY 99 to \$361.5 billion in FY 00. The total unsupported value for FY 00 involved 240 accounting entries.

The Accounting Service made 143 accounting entries for about \$307.8 billion to correct discrepancies between sources of accounting data without reconciling the differences between the two data sources or to determining which data source was correct. Here are the details:

- 5 entries for \$237.0 billion to force general ledger accounting data to agree with budgetary accounting data.
- 71 entries for \$45.3 billion to force intragovernmental transactions between trading partners to agree.
- 67 entries for \$25.5 billion to correct discrepancies between other sources of accounting data.

The remaining 97 entries for \$53.7 billion were made for reasons other than to correct discrepancies between sources of accounting data—for example to correct errors in previously prepared accounting entries—but didn't include all required supporting documentation.

For more than 9 years, budgetary status-of-appropriations data and expenditure data have been used to compile financial data for the Army General Fund financial statements. This is an interim method and is not acceptable, and the Army General Fund financial statements may not be auditable until an integrated, transaction-driven accounting system is implemented Armywide.

Subordinate Activity Adjustments

The Accounting Service needed to improve the internal controls for adjustments that activities formerly called Operating Locations made to financial information during the reporting process. During our review at one such activity we found that it met established timeframes for furnishing financial information to the Accounting Service-Indianapolis, but we also found some procedural problems. For example:

- Activity personnel made unsupported adjustments to make the general ledger agree with status data. The Accounting Service's reliance on status data rather than general ledger data in developing the Army's General Fund financial statements was a long-standing unresolved problem. Also, in an effort to comply with Accounting Service directives against reporting abnormal undelivered orders, activity personnel made temporary unsupported adjustments to eliminate abnormal undelivered orders totaling about \$85.6 million from status reports for 30 September 2000.

- Activity personnel made temporary adjustments with an absolute value of about \$678 million to correct Tables of Abnormal Balances errors in status data reported for 30 April 2000. However, because of workload constraints they didn't determine which adjustments affected the general ledger trial balances and adjust those balances. Activity personnel followed the same procedures at 30 September 2000; however, we didn't determine the amount of the adjustments. The resulting out-of-balance condition contributed to the unsupported departmental adjustment the Accounting Service-Indianapolis made to force the 30 September 2000 general ledger to agree with status data.

As a result of such problems, the accuracy and completeness of the data were questionable.

Performance Information

We conducted only a limited review of information on performance results that was presented in the Overview section. Although we obtained a basic understanding of the internal controls related to performance information, our procedures weren't designed to provide assurance on internal control over reported performance measures. Accordingly, we do not provide an opinion on such control. However, our control and compliance testing during the audit work for our various supporting reports identified significant problems with data reliability, and these problems could also affect the reliability of performance data.

FINANCIAL ACCOUNTS

In this section we discuss:

- Reporting of budgetary resources.
- Liabilities.
- Military payroll issues.
- Civilian payroll issues.
- Fund balance with Treasury.

- Problem disbursements.
- Progress payments.

Reporting of Budgetary Resources

The Accounting Service took some corrective action to address internal control problems we previously identified, but additional action is still needed. In the FY 99 Financial Reporting of Budgetary Resources Report, we concluded that internal controls weren't fully effective over the accounting, processing, and reporting of the obligations, recoveries, collections, disbursements, and reimbursables that we tested at the accounting office level. We made five recommendations for improving internal controls. Specifically, we recommended that the Accounting Service, in coordination with the Office of the Assistant Secretary of the Army (Financial Management and Comptroller):

- Change established procedures for classifying obligations and recoveries for reporting purposes. The Accounting Service agreed with the recommendation and estimated 30 June 2000 as the date to complete implementation. Although Accounting Service personnel had done work in response to this recommendation, it was only partially implemented.
- Issue policy guidance to have accounting offices reconcile imbalances between the accounting system's fund and history databases, implement procedures to ensure the databases remain in balance, and maintain or have ready access to detail automated support and documentation for all transactions. The Accounting Service agreed and originally estimated 30 September 2000 as the date to complete implementation, but corrective action wasn't completed.
- Conduct training for staff accountants on the use of reimbursement source codes and emphasize the importance of these codes. The Accounting Service agreed and said that the accountants would be trained in the use of reimbursement source codes as part of accounting courses scheduled at the Rock Island Field Activity. We verified that this action was taken.
- Issue policy guidance that emphasizes recording accounting data promptly and correctly, basing changes and corrections on thorough research, matching disbursements with the correct obligations, and recording transactions for correct amounts and in

the correct accounting periods. We verified that this action was taken.

- **Develop a single database for use by the auditors of the Army's financial statements that contains the detailed transactions that support the summary transactions used to prepare the Army's Standard Form 133s, Reports on Budget Execution, and the Army's financial statements. The Accounting Service disagreed with this recommendation but has not developed an acceptable alternative.**

As discussed with Accounting Service managers, implementation of these recommendations is essential prior to future detailed audit and testing of internal controls. We believe that without implementation of these recommendations, conditions will not significantly improve, similar control problems can be anticipated, and future audit may not be worthwhile.

Liabilities

Although reported liabilities included some costs that were incorrectly omitted in prior years, procedures and controls weren't adequate to ensure that all reported values were complete and accurate.

The Army's liability for environmental programs still needed improvement. Because project managers didn't have adequate documentation to support cost estimates, the \$9.9 billion environmental restoration liability (Active Army) was questionable. To prevent an overstatement of some environmental compliance liabilities, the Army needed to adjust its reporting to ensure that it recorded recurring projects as expenses of the period rather than liabilities. In addition, the Army couldn't fully report liabilities for unexploded ordnance on training ranges and national defense equipment disposal costs because of a lack of definitive guidance.

The Army also needed to improve its reporting of employer entity liabilities. The financial statements understated the liability for Temporary Early Retirement Authority payments and didn't recognize about \$380.4 million Voluntary Separation Incentives payments for the program's early takers. In addition, the statements didn't provide any disclosures on its Worker's Compensation liabilities. Such disclosure is necessary to adequately describe the time period reported and to ensure that the liability includes payments for Army Working Capital Fund claimants.

The Army did make progress in increasing controls for the \$12.2 billion Formerly Used Defense Site projects by implementing a new system that has some built-in financial management controls. In addition, the Army included liabilities for about \$409 million for contract holdbacks and \$79 million of installation level legal claims. Such claims had not been recognized on the Army's statements in previous fiscal years.

Military Payroll Issues

The Defense Finance and Accounting Service processes and controls over financial reporting were not adequate to ensure that the military pay and benefits cost data was correctly reported in the Army's General Fund Principal Financial Statements for FY 99 or FY 00. Specifically, the Accounting Service didn't:

- Maintain adequate work-around processes and controls for recording the Army military pay and benefits cost data in the financial statements.
- Correctly perform all required accrual accounting for military pay and benefits cost data, and didn't document the basis or logic of the accruals it had established.

As a result, the accuracy of the military pay and benefits cost data in the Statement of Net Cost and the payroll-related liability amounts in the balance sheet was questionable and there existed an unacceptable degree of risk of materially misstating the Statement of Net Cost. Furthermore, there was no audit trail for the \$25 billion of military pay and benefits in the Statement of Net Cost nor the approximately \$1.5 billion of payroll-related liabilities in the balance sheet. Unless this condition is corrected, it will continue to affect financial statements in the future. Correcting the condition will reduce the risk of material misstatement, improve the audit trails, and put the Army's General Fund financial statements in a better position for a favorable audit opinion in the future.

Civilian Payroll Issues

The Accounting Service's processes and controls over financial reporting were not adequate for accrued unfunded annual leave and annual leave expense. Specifically:

- Civilian Pay transactions were not always recorded correctly to the General Ledger.

- Accrued Unfunded Annual Leave was recorded incorrectly for the National Guard.
- Equity account was understated because of the incorrect Accrued Unfunded Annual Leave recorded for the National Guard.

These conditions reduced the reliability of the related dollar values reported in the Army's principal financial statements

Fund Balance With Treasury

Unresolved suspense account balances represented a material uncertainty regarding the reported amount for Fund Balance with Treasury. However, in FY 00 there was a significant reduction of other uncertainties such as Online Payment and Collection differences.

Suspense Account Balances

The Defense Finance and Accounting Service-Indianapolis didn't have effective procedures for monitoring and resolving accounting transactions placed into suspense accounts. As of 30 September 2000, the four records of suspense account balances ranged from a high of \$818.7 million to a low of \$6.0 million. One of the other two records of suspense account balances included \$246.7 million that had been in suspense for over one year. Differing suspense account balances and old account balances indicate problems with the validity and monitoring of suspense account transaction data. Although the Accounting Service-Indianapolis recognized in FY 97 that material management control weaknesses existed with the reconciliation of suspense account balances, no effective program to monitor and correct differences was established. As a result, suspense account balances were a material uncertainty affecting the amount reported for Fund Balance With Treasury, and there was no assurance that existing suspense account differences would be corrected or that future differences will be resolved.

Other Uncertainties

In prior years, other uncertainties such as check issue reporting discrepancies (including check detail discrepancies and "paid no issue" checks), Online Payment and Collection differences, and deposit/electronic fund transfer differences were material regarding Fund Balance With Treasury. However, the Accounting Service-Indianapolis significantly reduced these differences during FY 00.

Differences not caused by timing decreased from about \$279 million as of 30 September 1999 to about \$28 million as of 30 September 2000. The cumulative amount of these uncertainties was not material regarding the Fund Balance with Treasury reported on the FY 00 financial statements.

Problem Disbursements

Problem disbursements represent a significant financial reporting issue for the Army, but the reported status at yearend indicated that much progress occurred during FY 00. Two primary categories of problem disbursements are unmatched disbursements (UMD—disbursement transactions that accounting offices have not matched to the correct detail obligations in the accounting records) and negative unliquidated obligations (NULO—disbursement transactions that exceed the value of the matching detail obligations).

The Army's goal was to reduce these two categories of problem disbursements by 75 percent from September 1998 to September 2000. At the end of this period the Army reported unmatched disbursements of \$387 million and negative unliquidated obligations of \$187 million. This represented a reduction of 87 percent and 70 percent respectively.

The Accounting Service has reported multiple material weaknesses related to problem disbursements in its annual assurance statements. Resolution is expected by FY 03 according to its current assurance statement. The Army and the Accounting Service previously established a Joint Reconciliation Program to increase their combined efforts to solve this issue. These efforts are continuing during FY 01.

Progress Payments

The Accounting Service changed its procedure in FY 00 regarding the recording of contract holdbacks. During FY 96, we identified problems with recording holdbacks related to progress payments. In our report on progress payments for the FY 96 financial statements, we recommended that the Accounting Service:

- **Modify Army accounting systems to provide for recording of contract holdbacks and use the systems to record holdbacks related to progress payments**
- **Make sure actual progress payment rates are used when calculating contract holdback amounts.**

- Review trial balances submitted by operating locations and accounting offices to make sure that stations reporting account balances for contract holdbacks also report an account balance for the corresponding asset account.

The Accounting Service agreed to test the recommendation to review trial balances, but didn't agree to modify systems to provide for recording of contract holdbacks or to make sure actual progress payment rates were used when calculating contract holdback amounts.

On 2 October 1998, the Office of Management and Budget made a decision that supported our position. However, DOD didn't implement this decision and indicated that it intended to challenge it. Although we didn't conduct detailed audit work in this area for FY 99, we estimated the effect on the financial statements would be material. We performed a similar limited review for FY 00 and found that the Accounting Service had begun recording contract holdbacks during the year. However, this limited review didn't enable us to verify the extent of the Accounting Service's action. We will evaluate this area further during future audit work.

PROPERTY ACCOUNTS

In this section we discuss:

- Real property.
- Construction-in-progress.
- General equipment.
- Inventory.
- Supplemental stewardship reporting.

Real Property

The Army made some progress during FY 00, but the progress wasn't sufficient to correct previously reported problems. As a result, there is considerable uncertainty about the reliability of the \$11.8 billion reported value for real property.

The Army made definite progress in fielding the interface between automated real property systems and the Defense Property Accountability System during FY 00. For example:

- The Army fielded the software it needed to interface real property data between the Integrated Facilities System and the Defense Property Accountability System.
- Army installations began interfacing real property data with the Defense Property Accountability System at all Army activities except the Army National Guard.

However, because the Army wasn't able to completely field and test interfaces in time for the FY 00 financial statements, it continued to use the Headquarters Executive Information System for financial statement reporting. As we reported in FY 99, this system doesn't provide reliable enough information for reporting capital improvements and depreciation amounts. In addition, audit trails within the Integrated Facilities System aren't adequate to trace changes in previously recorded costs and to fully identify transactions affecting real property facility balances.

The Army also hasn't corrected the internal control issues we reported in FY 99. The Assistant Chief of Staff for Installation Management was still developing a policy memorandum to address the internal control issues we identified in our FY 99 financial statement audit. Our analysis of the policy memorandum identified an additional control that was needed to fully comply with our recommendations.

In addition, the Army does not yet have a valid beginning balance for audit purposes. The public accounting firm PricewaterhouseCoopers completed its contracted effort to assess the recorded values in the real property databases and provided a favorable recommendation to DOD. However, the General Accounting Office and the Inspector General, DOD haven't yet approved the firm's recommendation. We will continue to monitor the efforts of these audit agencies to resolve their differences with the contractor and DOD.

Construction-in-Progress

The Army National Guard did not have controls and systems in place to ensure that its construction in progress costs were accurately reported in the Army's General Fund Financial Statement.

Personnel at Army National Guard activities collected construction in progress costs. These costs were maintained and reported by each state in the standard accounting system. But, the accounting system was not a general ledger based system; and it didn't interface with the Departmental General Ledger System at the Defense Finance and Accounting Service-Indianapolis. The Army National Guard had not established an alternate process of capturing and reporting the construction in progress balance to the Accounting Service.

As a result, the Property, Plant, and Equipment balance reported on the Army's General Fund Consolidated Balance Sheet was understated by the construction in progress costs funded by the Army National Guard. At the end of FYs 99 and 00, we estimated that the Army National Guard had at least \$92 million and \$86 million, respectively, in unrecorded construction in progress costs.

General Equipment

Controls, procedures, and systems weren't adequate to ensure the accurate reporting of general equipment values. Standard Army systems do not capture the correct acquisition data and cost, and most current Army systems were not designed to produce required financial information. The Army reported this problem as an uncorrected material weakness in FY 00.

In FY 99, the Army began fielding the Defense Property Accountability System to meet and comply with financial reporting standards. Because fielding wasn't completed in FY 00, the Army again used an Armywide data call to determine general equipment values and calculate related depreciation for the FY 00 financial statements. A reporting team at the U.S. Army Materiel Command's Logistics Support Activity conducted the data call. To improve the reliability of reported data, the reporting team began the process of establishing a general equipment baseline. During this process it identified activities that were excluded from the FY 99 reported amounts, and identified and corrected obvious errors and omissions.

Although the timing of the data call limited our ability to perform the tests necessary to validate the general equipment values in the FY 00 financial statements, we conducted analytical tests over the

reasonableness of the data from the units and the resulting values the reporting team reported. We found numerous errors and inconsistencies that led us to question the reliability and completeness of the reported \$1.15 billion of general equipment.

Inventory

The Army made some reporting improvements, but internal controls were not fully effective over the reporting of wholesale munitions as inventory. Also, the Army was still evaluating the criteria for reporting additional operating materials and supplies.

Wholesale Munitions

U.S. Army Operations and Support Command (formerly U.S. Army Industrial Operations Command) had taken satisfactory corrective actions on the USAAA recommendations we reviewed. We found that U.S. Army Aviation and Missile Command operating personnel had initiated corrective actions to a recently issued General Accounting Office audit report on the FY 99 financial statements reporting of munitions inventories. However, we concluded that, based on the recent issuance date of the audit report, additional actions and time is required to fully finalize and implement the agreed to recommendations. Further, we determined that milestone target dates are needed to ensure that the recommendations are implemented timely. We found that DA generally disagreed with two recommendations in an Inspector General, DOD audit report relative to FY 99 General Fund financial statement munitions inventories. We will verify the resolution of the disagreements during future audit work.

As a part of our FY 00 audit work, we also determined that the U.S. Army Operations Support Command didn't totally fund annual physical inventory accomplishments for about \$14.0 billion, or 68 percent, of the total \$20.6 billion of wholesale munitions reported as Operating Materials and Supplies. The command reported unfinanced requirements, totaling about \$6.3 million of workload, related to inventorying assets classified as Category III and IV munitions. Operating personnel at Operation Support Command also stated that about \$4.8 million of unfinanced inventory requirements were expected for FY 01. Operating personnel at Aviation and Missile Command stated that although all FY 00 inventory requirements were accomplished, unfinanced inventory requirements totaling about \$658,000 were expected for FY 01. Annual physical inventories are a significant internal control needed to support DA's financial statement assertions of existence and completeness.

Additional Operating Materials and Supplies

The Army and DOD have action ongoing to identify the types of items in addition to wholesale munitions that should be reported as operating materials and supplies. The particular issue being reviewed is determining the conditions for using the purchase method versus the consumption method. Under the purchase method, items are expensed when they are purchased. Under the consumption method, items are reported as assets when they are purchased and expensed when they are issued to an end user. This ongoing action is included in the Army's strategic plan, and the final outcome will directly affect the reported amount of operating materials and supplies.

Supplemental Stewardship Reporting

The process and procedures that the Army used to capture and report National Defense Equipment didn't provide reasonable assurance that the data was accurate and complete. Although the Army developed an action plan to capture and report National Defense Equipment in the Required Supplemental Stewardship Information section of the Army's General Fund FY 00 Financial Statements, the plan was not fully effective because the logistical systems that the Army planned to use could not be relied upon for accurate data. Here are some of the problems we found:

- The Commodity Command Standard System—the system the Army planned to use to capture additions and deletions—either overstated or understated additions because of the time between the date equipment was received and the date the equipment was recorded in the Standard System.
- The Standard System didn't record equipment stored at contractor facilities because acquisitions frequently weren't entered into the Standard System until items were received by the Depot or using activity. Therefore, equipment accepted and held at contractor plants wasn't recorded in the Standard System.
- The Standard System didn't record equipment turned-in by units or installations directly to Defense Reutilization and Marketing Offices for disposal. This occurred because the Standard System only recorded transactions effecting the wholesale system.

- The Standard System recorded disposals (deletions) at the time disposition instructions were given instead of when the equipment was actually disposed of—which could be months later.

As a result of these system problems, the Army reverted to a manual data call to capture and report additions and deletions. However, because the Army didn't provide timely guidance or training to the persons compiling National Defense Equipment data, there were several problems related to the data call process. Specifically:

- The processes for collecting additions and deletions didn't provide an adequate audit trail. Most persons reporting the data didn't retain documentation to support the numbers they reported.
- To compute additions, personnel used contractors' shipping dates instead of actual acceptance dates, or they plugged the numbers based on the difference between the beginning and ending balances.
- To compute deletions, personnel used disposition instructions, or they plugged numbers based on the difference between the beginning and ending balances. They didn't use actual disposal dates to collect data for deletions.

As a result, the Army had no assurance that the numbers it reported for additions and deletions on the National Defense Equipment Supplemental Stewardship Report were reasonably accurate or complete.

**REPORT ON COMPLIANCE WITH LAWS
AND REGULATIONS**

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The Army isn't yet able to fully comply with the Chief Financial Officers Act of 1990 and related requirements. However, during our review of compliance with laws and regulations, we found no material instances of unreported legal or regulatory infractions.

We tested the Army's compliance with selected provisions of laws and regulations throughout the audit. Instances of noncompliance are reportable if they could result in material misstatements to the financial statements, or if the sensitivity of the matter would cause others to perceive it as significant.

The noncompliance problems we identified were directly or indirectly tied to internal control weaknesses and the Army's inability to fully comply with the Chief Financial Officers Act (and related implementing guidance) and Federal accounting standards. We discuss these problems in the Report on Internal Controls.

We also tested and reviewed compliance with certain key laws that affected the Army's ability to produce reliable financial statements. We provide some details in the following paragraphs. However, the objective of our audit wasn't to provide an opinion on the Army's overall compliance with laws and regulations, and we do not express such an opinion.

Chief Financial Officers Act

We evaluated the Army's compliance with the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994, and various implementing regulations issued by the Office of Management and Budget and DOD, as they relate to presentation of information in financial statements. The Army and the Accounting Service have made a concerted effort to meet the act's requirements. But current management and accounting systems weren't designed for financial statement reporting, and they can't produce reliable and auditable financial statements. Until system deficiencies are resolved, the Army and the Accounting Service will be unable to produce statements that conform to prescribed accounting guidance. Nevertheless, we have identified areas in which the Army and the Accounting Service can achieve financial reporting improvements over the short term. We discuss these areas and the necessary corrective

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actions in the Report on Internal Controls and in the supporting audit reports listed in Annex C.

Anti-Deficiency Act

We evaluated the Army's compliance with the Anti-Deficiency Act as part of our review of the compilation of the financial statements at the Accounting Service-Indianapolis. Our review at that level didn't identify any potential violations of the act. However, because the Army's problem disbursements have not been resolved, we could not fully verify the Army's compliance with the act.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act of 1982 requires the Army and the Defense Finance and Accounting Service to report annually to the Secretary of Defense about whether their management controls comply with the act's requirements. In their respective FY 00 annual assurance statements, the Army and the Accounting Service reported several management control weaknesses involving noncompliance with prescribed accounting principles, standards, and related requirements. The specific weaknesses most directly related to the Army's financial statements follow. Summaries of these weaknesses are in Annex B.

Army Assurance Statement

The Army reported nine uncorrected material weaknesses for FY 00. The following weaknesses most directly affect the accuracy and reliability of the Army's financial statements:

- Financial Reporting of Real Property and General Equipment.
- Information Systems Security.
- Equipment In-Transit Visibility.
- Management of Unexploded Ordnance and Other Constituents.

Defense Finance and Accounting Service Assurance Statement

The Accounting Service reported 38 uncorrected material weaknesses for FY 00. Here are examples of weaknesses that directly affect the accounting data that the Accounting Service uses to prepare the Army's principal financial statements.

- General Ledger Control and Financial Reporting.
- Reconciliation of Suspense Account Balances.
- Interface Between Contract Payment and Accounting Systems (Negative Unliquidated Obligations (NULO) and Unmatched Disbursements).
- Systems Interface Between Computerized Accounts Payable System (CAPS) and Standard Army Finance Systems Redesign (SRD-1).
- Problem Disbursements.
- Defense Joint Military Pay Systems (DJMS) Requirements and Systems Specifications Documentation.
- Fund Balances with Treasury.

Federal Financial Management Improvement Act

The Federal Financial Management Improvement Act of 1996 requires each Federal agency to implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards and the U.S. Government Standard General Ledger at the transaction level. The act also requires that we report on agency compliance with these requirements.

Financial management systems didn't meet the requirements of the Federal Financial Management Improvement Act of 1996. The lack of a single integrated general ledger and the differences between status of appropriation data and the general ledger data complicated the financial statement compilation process. The Accounting Service-Indianapolis made material adjustments to the general ledger data to make it match the status of appropriation data without knowing the reasons for the differences.

The Assistant Secretary of the Army (Financial Management and Comptroller) has stated that the Army cannot provide reasonable assurance that the accounting and non-accounting systems used to record and report Army financial data are reliable because they don't meet the standards set by the Office of Management and Budget. Therefore the Army uses a consolidation of accounting data from source documents, budgetary accounting systems, and multiple field-level and department-level data inputs to produce the financial statements.

DOD has also acknowledged the existence of problems with the financial systems. In its Annual Statement of Assurance for FY 00, the Accounting Service stated:

The Department's financial management systems, taken as a whole, were not designed to meet various requirements and standards, many of which have been implemented within the [past] few years. Therefore, the systems are not capable of producing financial information that can fully satisfy the demands of financial audits.

The Army (primarily for the feeder systems) and the Accounting Service (primarily for the accounting systems) each have responsibilities to meet the requirements of this act

AUDIT SCOPE AND METHODOLOGY

AUDIT SCOPE AND METHODOLOGY

Army management, with support provided by the Defense Finance and Accounting Service, is responsible for:

- Preparing the annual financial statements in conformity with applicable accounting principles.
- Establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met.
- Complying with applicable laws and regulations.

We were responsible for evaluating the financial statements, related internal controls, and compliance with laws and regulations. In carrying out these responsibilities, we:

- Evaluated and, as necessary, tested selected internal controls related to:
 - The overall process for compiling the financial statements.
 - Liabilities.
 - Payroll.
 - Fund balance with Treasury.
 - Subordinate activity adjustments.
 - Property, plant and equipment.
- Conducted limited followup reviews on previously reported problems and recommendations related to:
 - Accounting systems.
 - Reporting of budgetary resources.
 - Problem disbursements
 - Progress payments.
 - Inventory.

- Evaluated compliance with selected laws and regulations.
- Reviewed the Overview section of the Annual Financial Report for consistency with data reported in the financial statements.

We didn't conduct audit work on programs that were classified for national security.

Except for the limitations on our work described in the body of this report, we performed our work in accordance with generally accepted government auditing standards and Office of Management and Budget Bulletin 01-02 (Audit Requirements for Federal Financial Statements).

ANNEXES

REPORTED MATERIAL WEAKNESSES

In the annual assurance statements for FY 00, the Army and the Defense Finance and Accounting Service both reported uncorrected material internal control weaknesses that directly relate to the Army's financial statements.

Army Assurance Statement

The Army reported nine uncorrected material weaknesses for FY 00, and four directly related to the accuracy and reliability of the Army's financial statements. Here is a summary of these four weaknesses as reported in the assurance statement.

1. Financial Reporting of Real Property and General Equipment.

The Army does not currently meet Federal accounting standards for the financial reporting of real property and general equipment. These standards require Federal agencies to present fairly the cost and depreciation of these assets in their financial statements. To meet this requirement, Army records must capture the correct acquisition date and cost. In most cases, current Army systems weren't designed to produce such information. As a result, information on acquisition date and cost is not always available or accurate. The Army's inability to identify an item's acquisition date and cost prevents the computation of depreciation and the determination of value for financial reporting. (Identified: FY 99. Resolution Target: FY 02.)

2. Information Systems Security. Unauthorized personnel have successfully attacked and penetrated the Army's unclassified automated information systems and telecommunications networks. These intrusions have led to the identification of systemic deficiencies in systems and network security design and implementation; incident response, containment, and implementation of countermeasures; and information systems security education, training, awareness; and professional development. To correct these weaknesses, Army leadership has, in the Command and Control Protect Program Management Plan, outlined the measures it will take to ensure the Army's portion of the Defense information infrastructure is adequately protected. (Identified: FY 96. Resolution Target: FY 03.)

3. Equipment In-Transit Visibility. Systems interface and logistics process problems cause a significant portion of the in-transit records displayed by the Continuing Balance System-Expanded to be invalid. Equipment involved had been received and reported as on hand by the

receiving units, but the receipt transactions didn't close out the shipment (in-transit) records. As a result, the Army didn't have reliable data about the value of equipment in-transit, and the value of in-transit equipment reported in the Army's financial statements was misstated by a significant but unknown amount. (Identified: FY 96. Resolution Target: FY 01.)

4. Management of Unexploded Ordnance and Other Constituents.

Neither the Army nor DOD has an effective, integrated and proactive unexploded ordnance management program that addresses the full life-cycle perspective of ranges, land withdrawal, munitions, and unexploded ordnance. Also, neither the Army nor DOD has ready access to necessary science and technology information to accurately assess and predict the operational, safety, health, and environmental or fiscal impacts to ensure the unexploded ordnance on ranges is being proactively managed. (Identified: FY 98. Resolution Target for Phase One: FY 02.)

Defense Finance and Accounting Service Assurance Statement

The Accounting Service reported 38 uncorrected material internal control weaknesses for FY 00. Here are summaries of some of the reported weaknesses that most directly affect the Army's financial statements as reported in the assurance statement.

1. Inadequate General Ledger Control and Unreliable Financial Reporting. The Accounting Service has a material internal control weakness in general ledger and financial reporting that is attributable to many factors in the control environment, accounting and related systems, and control procedures. Overall, the accounting systems don't have general ledgers that permit adequate recording and reporting of financial transactions. Each DOD accounting system has its own general ledger, and efforts to implement the U.S. Government Standard General Ledger are continuing. Effective control procedures over accounting and reporting will be impossible until a single, standard general ledger is developed and implemented in the DOD systems. (Identified: FY 91. Resolution Target: FY 03.)

2. Reconciliation of Suspense Account Balances. Suspense account balances require extensive reconciliations to ensure that the accounts are used properly, supported by adequate documentation, cleared in a timely manner, and are in agreement with Treasury balances. Transactions residing in suspense accounts can conceal

problem disbursements and fraud. (Identified: FY 97. Resolution Target: FY 02.)

3. Interface Between Contract Payment and Accounting Systems (Negative Unliquidated Obligations (NULO) and Unmatched Disbursements). Both negative unliquidated obligations and unmatched disbursements are evidence of the same type of weakness: the presence of error conditions in the interface between systems and accounting systems. In DOD, payment operations for the most part are distinct from accounting, even when the payment operations are a component of the same accounting and finance office. Differences between payment systems and accounting systems are not revealed until payments are improperly recorded in the accounting systems. Large out-of-balances exist in undistributed disbursement and collection accounts and in unliquidated obligation accounts. The capabilities of the accounting systems don't permit the research of unmatched document numbers. Personnel performing reviews aren't adequately trained, and review-sampling methods are inadequate. (Identified: FY 90. Resolution Target: FY 02.)

4. Inadequate Systems Interface Between Computerized Accounts Payable System (CAPS) and Standard Army Finance System Redesign (SRD-1). The ASCII file used to update SRD-1 with accounts payable payment information can be changed. The file is unprotected and can be accessed by anyone who can read and/or change an ASCII file. As a result, any individual with access to the file can alter the information. Also, the Computerized Accounts Payable System does not have the capability to restrict access to the "remit to" address file for associates computing vendor payments. The lack of internal controls, edit checks, and audit trail in the Accounts Payable System has the potential for fraud and the misuse of government funds. (Identified: FY 98. Resolution Target: FY 01.)

5. Problem Disbursements. The Defense Finance and Accounting Service-Indianapolis is working with DOD agencies to fully identify and resolve problem disbursements. There are three categories of problem disbursements: in-transits (paid by a disbursing office but not yet received by the funded station); unmatched disbursements (disbursements that accounting stations have not matched to obligations in the accounting records); and negative unliquidated obligations (disbursements that exceed the value of the matching detail obligations). Primary causes of problem disbursements relate to the lack of integration between the entitlement systems and the accounting systems, and errors/delays in posting disbursements to accounting records. The occurrence of problem disbursements distorts fund availability. (Identified: FY 96. Resolution Target: FY 03.)

6. Fragmented and Incomplete Defense Joint Military Pay System (DJMS) Requirements and Systems Specifications

Documentation. Comprehensive sets of requirements, business rules, and systems documentation doesn't exist for either the Active or Reserve Components of the system. Some documentation is maintained only in functional work areas and some is maintained in the programmer/analyst work areas. Not all existing information is current. Failure to have documented systems severely impairs and adversely impacts the primary mission of hosting and modifying military pay software with acceptable degrees of confidence and reliability. (Identified: FY 99. Resolution Target: FY 02.)

7. Fund Balances with Treasury. Appropriation balances recorded in the accounting records do not balance to the fund balances with the Treasury. (Identified: FY 99. Resolution Target: FY 01.)

SUPPORTING AUDIT REPORTS

1. **Military Pay and Benefits (Audit Report 01-166, 31 January 2001)**
2. **Civilian Pay (to be published)**
3. **Construction-in-Progress (to be published)**
4. **National Defense Equipment (to be published)**
5. **General Equipment (to be published)**
6. **Real Property (to be published)**
7. **Liabilities (to be published)**
8. **Munitions (to be published)**
9. **Budgetary Resources (to be published)**
10. **Field Activity Adjustments (to be published)**
11. **Inspector General, DOD Audit of the Compilation of the Army's FY 00 Financial Statements at the Defense Finance and Accounting Service-Indianapolis (to be published)**

OTHERS RECEIVING COPIES OF THE REPORT

Chief of Staff, Army
 Under Secretary of the Army
 Vice Chief of Staff, Army
 Assistant Secretary of the Army (Civil Works)
 Assistant Secretary of the Army (Financial Management and Comptroller)
 Assistant Secretary of the Army (Installations and Environment)
 Assistant Secretary of the Army (Manpower and Reserve Affairs)
 Assistant Secretary of the Army (Acquisition, Logistics and Technology)
 General Counsel
 Director of the Army Staff
 The Inspector General
 Chief of Legislative Liaison
 Chief of Public Affairs
 Chairman, Army Reserve Forces Policy Committee
 Deputy Chief of Staff for Logistics
 Deputy Chief of Staff for Operations and Plans
 Deputy Chief of Staff for Personnel
 Assistant Chief of Staff for Installation Management
 Chief, National Guard Bureau
 Deputy Assistant Secretary of the Army for Budget
 Director, Program Analysis and Evaluation
 Commanding General, U.S. Army, Europe and Seventh Army
 Commanders
 U.S. Army Forces Command
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 U.S. Army Military District of Washington
 U.S. Army Corps of Engineers
 U.S. Army Criminal Investigation Command
 U.S. Total Army Personnel Command
 U.S. Army Aviation and Missile Command
 U.S. Army Communications-Electronics Command
 U.S. Army Industrial Operations Command
 U.S. Army Tank-automotive and Armaments Command
 U.S. Army Logistics Integration Agency
 U.S. Army War Reserves Support Command
 XVIII Airborne Corps and Fort Bragg
 I Corps and Fort Lewis
 3rd MP Group, USACIDC
 6th MP Group, USACIDC

Executive Director, U.S. Army Materiel Command Logistics Support Activity

Directors

Armament and Chemical Acquisition and Logistics Activity

U.S. Army Research Laboratory

U.S. Army Center for Public Works

Commandant, U.S. Army Logistics Management College

Director, Center for Army Lessons Learned

Inspector General, Department of Defense

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Defense Finance and Accounting Service

Defense Finance and Accounting Service-Indianapolis

Defense Finance and Accounting Service-Columbus

Defense Intelligence Agency

Defense Logistics Agency

Auditors General

Air Force Audit Agency

Naval Audit Service

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