Audit Report

INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR THE DOD AGENCY-WIDE FINANCIAL STATEMENTS FOR FY 2000

Report No. D-2001-070

February 28, 2001

Office of the Inspector General
Department of Defense

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Acronyms

CFO	Chief Financial Officer
DFAS	Defense Finance and Accounting Service
FBWT	Fund Balance With Treasury
FFMIA	Federal Financial Management Improvement Act of 1996
FMIP	Financial Management Improvement Plan
GPRA	Government Performance and Results Act of 1993
IG	Inspector General
ODO	Other Defense Organizations
OMB	Office of Management and Budget
PP&E	Property, Plant, and Equipment
SAS	Statement on Auditing Standards
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standards
USD(C)	Under Secretary of Defense (Comptroller)
USGSGL	U.S. Government Standard General Ledger
WCF	Working Capital Fund

INSPECTOR GENERAL
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February 28, 2001

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

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and Regulations for the DoD Agency-Wide Financial Statements for FY 2000 (Report No. D-2001-070)

We are providing this audit report for your information and use. We considered management comments on a draft of this report when preparing the final report. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare annual financial statements. We conducted this audit in accordance with Government auditing standards and the requirements of the Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal 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. The Under Secretary of Defense (Comptroller) provided comments. The complete text of the comments is in the Management Comments section of the report.

We were unable to express an opinion on the DoD Agency-Wide financial statements for FY 2000 because internal control weaknesses, compilation problems, and deficiencies in financial management systems continued to exist. This report discusses material weaknesses and reportable conditions, which were also reported in the management representation letter for the DoD Agency-Wide financial statements for FY 2000, the DoD Components' Annual Statements of Assurance, and the DoD Financial Management Improvement Plan. Our disclaimer of opinion on the DoD Agency-Wide financial statements for FY 2000 is Exhibit 3.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Richard B. Bird at (703) 604-9159 (DSN 664-9159) (rbird@dodig.osd.mil) or Ms. Cindi Miller at (317) 510-3855 (DSN 699-3855) (cmiller@dodig.osd.mil). See Appendix E for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Office of the Inspector General, DoD

Report No. D-2001-070 **February 28, 2001**

Project No. D2001FI-0018.002

Internal Controls and Compliance With Laws and Regulations for the DoD Agency-Wide Financial Statements for FY 2000

Executive Summary

Introduction. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare annual audited financial statements. This is the first in a series of reports related to the DoD Agency-Wide financial statements for FY 2000.

The DoD Agency-Wide financial statements for FY 2000 were compiled from the financial statements of the DoD reporting entities: the Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; the Military Retirement Fund; the U.S. Army Corps of Engineers, Civil Works Program; and financial data for the Other Defense Organizations-General Funds and Working Capital Funds. In FY 2000, the DoD Components reported total assets of $616.7 billion, total liabilities of $1.0 trillion, total net costs of operations of $347.5 billion, and total budgetary resources of $656.1 billion.

Audit Objectives. Our overall objective was to determine whether the DoD Agency-Wide financial statements for FY 2000 were prepared in accordance with Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended, and generally accepted accounting principles. We also evaluated internal controls and compliance with laws and regulations.

Disclaimer of Opinion. DoD could not provide sufficient or reliable information for us to verify amounts on the FY 2000 DoD Agency-Wide Financial Statements. We identified deficiencies in internal controls and accounting systems related to General Property, Plant, and Equipment; Inventory; Environmental Liabilities; Military Retirement Health Benefits Liability; and material lines within the Statement of Budgetary Resources. The DoD processed at least $4.5 trillion of department-level accounting entries to the DoD Components financial data used to prepare departmental reports and the DoD Agency-Wide financial statements for FY 2000. Also, $1.2 trillion in department-level accounting entries to financial data, used to prepare DoD Component financial statements, were unsupported because of documentation problems or improper because the entries were illogical or did not follow generally accepted accounting principles.

The financial data reported on the FY 2000 financial statements for Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; and the U.S. Army Corps of Engineers, Civil Works Program, were unauditable and comprise a significant portion of the financial data reported on the FY 2000 DoD Agency-Wide Financial Statements. Because internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist, we were unable to perform adequate audit tests of the financial statements. As a result, we do not express an opinion on the FY 2000 DoD Agency-Wide Financial Statements.

Review of Internal Controls. The objective of our audit was not to provide assurance on internal controls. Consequently, we did not express an opinion on internal controls. Our review of internal controls included applicable tests of the internal controls to determine whether the controls were effective and working as designed. We concluded that DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the FY 2000 DoD Agency-Wide Financial Statements, the DoD Components' Annual Statements of Assurance, and the DoD Financial Management Improvement Plan.

Review of Compliance With Laws and Regulations. Our objective was to assess compliance with laws and regulations related to the DoD Agency-Wide financial statements for FY 2000 and not to express an opinion. Therefore, we did not express an opinion on DoD compliance with laws and regulations. However, DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine the amounts reported on the financial statements. We identified noncompliance issues related to the Federal Financial Management Improvement Act of 1996; Statements of Federal Financial Accounting Standards; the Chief Financial Officers Act of 1990; section 3512, title 31, United States Code (formerly the Federal Managers' Financial Integrity Act of 1982); laws governing the claims of the United States government; and the Government Performance and Results Act of 1993.

Management Comments. Although no comments were required, the Deputy Chief Financial Officer, provided general comments on the report. He stated that the Department was improving its financial operations, but did not have sufficient time to review and determine the validity of individual assertions in the report. The Deputy Chief Financial Officer also stated that they were not provided detail on the accounting entries considered unsupported and that the accounting entries are not a normal part of the Department's day-to-day accounting processes.

Audit Response. The Department did not provide financial statements for audit until about 3 months after fiscal year end. Also, the published FY 2000 DoD Agency-Wide Financial Statements differed significantly from the financial statements originally presented for audit. In order to comply with Office of Management and Budget reporting timeframes, we were only able to provide limited time for comments on this report. Although many accounting entries are made to prepare the financial statements, other accounting entries correct errors caused by improper system interfaces, day-to-day accounting problems, and long-standing deficiencies. Although these problems persist, we agree that DoD has made progress in reducing the number and value of accounting entries. We met with key DoD accounting officials throughout the year and provided details of the problems with the unsupported accounting entries. Specific matters summarized in this report will be addressed in subsequent reports by the IG, DoD and the Service Audit Agencies.

Table of Contents

Background

Reporting Requirements. 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 financial statements. Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," dated October 16, 2000, establishes the minimum requirements for audits of Federal financial statements. This is the first in a series of reports related to the DoD Agency-Wide financial statements for FY 2000.

Accounting Functions and Responsibilities. The Under Secretary of Defense (Comptroller) (USD[C]), as the Chief Financial Officer (CFO), is responsible for overseeing all financial management activities related to the programs and operations of DoD. The Defense Finance and Accounting Service (DFAS) performs accounting functions and prepares financial statements for DoD. DFAS operates under the control and direction of the USD(C). DFAS is responsible for entering information from DoD entities into finance and accounting systems, operating and maintaining the finance and accounting systems, and ensuring the continued integrity of the information entered. The DoD reporting entities are responsible for providing accurate financial information to DFAS through feeder systems and other processes.

Internal Control Responsibilities. As the CFO, the USD(C) oversees all financial management activities for DoD programs and operations, including the accounting functions of DFAS. The Military Departments, Defense agencies, and DoD field activities are responsible for managing their operations. Establishing and maintaining internal controls appropriate to the entity is an important management responsibility. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;

- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation;

- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and with any laws and regulations that OMB, DoD, or the Inspector General (IG), DoD, have identified as being significant and for which compliance can be objectively measured and evaluated; and

- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Compliance Responsibilities. The CFO is also responsible for compliance with laws and regulations applicable to the DoD Agency-Wide financial statements. The Military Departments, Defense agencies, and DoD field activities are responsible for compliance with laws and regulations applicable to their organizations. Compliance with laws and regulations is an important management responsibility and is essential for proper financial reporting.

Accounting Policy. The DoD Agency-Wide financial statements for FY 2000 were to be prepared in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended September 11, 2000. Footnote 1 to the financial statements discusses the significant accounting policies followed in preparing the financial statements.

Scope of DoD Operations. In employment and discretionary spending authority, DoD is the largest Government agency. In FY 2000, DoD employed about 2.1 million active-duty Service members and civilian personnel and about 0.9 million reservists. In FY 2000, the DoD Components reported total assets of $616.7 billion, total liabilities of $1.0 trillion, total net costs of operations of $347.5 billion, and total budgetary resources of $656.1 billion.

Disclaimer of Opinion. DoD could not provide sufficient or reliable information for us to verify amounts on the FY 2000 DoD Agency-Wide Financial Statements. We identified deficiencies in internal controls and accounting systems related to General Property, Plant, and Equipment; Inventory; Environmental Liabilities; Military Retirement Health Benefits Liability; and material lines within the Statement of Budgetary Resources. Also, $1.2 trillion in department-level accounting entries to financial data, used to prepare DoD Component financial statements, were unsupported because of documentation problems or improper because the entries were illogical or did not follow generally accepted accounting principles.

The financial data reported on the FY 2000 financial statements for Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; and the U.S. Army Corps of Engineers, Civil Works Program, were unauditable and comprise a significant portion of the financial data reported on the DoD Agency-Wide financial statements for FY 2000.

Because internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist, we were not able to perform adequate audit tests of the various line item amounts reported on the financial statements. As a result, we do not express an opinion on the FY 2000 DoD Agency-Wide Financial Statements. Our disclaimer of opinion is Exhibit 3.

Objectives

Our overall objective was to determine whether the DoD Agency-Wide financial statements for FY 2000 were prepared in accordance with Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended, and generally accepted accounting principles. We also evaluated internal controls and compliance with laws and regulations. See Appendix A for a complete discussion of the scope, methodology, and prior coverage.

Review of Internal Controls

Overview of Material Weaknesses

Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal controls does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited, and would not be detected in a timely manner by employees in the normal course of performing their functions.

The objective of our audit was not to provide assurance on internal controls. Consequently, we did not express an opinion on internal controls. We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free from material misstatements. DoD internal controls did not ensure that accounting entries to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the FY 2000 DoD Agency-Wide Financial Statements (Exhibit 1), the DoD Components' Annual Statements of Assurance for FY 2000, and the DoD Financial Management Improvement Plan (FMIP).

Statement on Auditing Standards (SAS) No. 82, "Consideration of Fraud in a Financial Statement Audit," February 1997, requires us to specifically assess the risk of material misstatement of the financial statements because of fraud and to consider that assessment in designing audit procedures to be performed. We included an assessment of fraud risk in our review of internal controls.

Internal Control Components

SAS No. 78, "Consideration of Internal Controls in a Financial Statement Audit; An Amendment to SAS No. 55," December 1995, defines internal controls as a process performed by an entity's board of directors, management, or other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

SAS No. 78 states that internal controls consist of five interrelated components:

- the control environment,
- risk assessment,
- control activities,
- information and communication, and
- monitoring.

Control Environment

The control environment includes factors that set the tone of an organization, influencing the control consciousness of its employees. The control environment includes several organizational factors, such as management's philosophy and commitment to competence. The ability of DoD to prepare auditable financial statements would be improved if:

- DoD continued to revise system improvement plans;
- DoD provided adequate guidance to the DoD Components for preparing financial statements; and
- the CFO provided auditable and timely financial statements.

We identified similar problems with DoD financial reporting guidance and financial statements for FYs 1997, 1998, and 1999. A discussion of these issues was included in IG, DoD, Reports on Internal Controls and Compliance with Laws and Regulations for the DoD Agency-Wide financial statements for FYs 1997, 1998, and 1999.

Plans to Improve Financial Management. As in past years, the overarching deficiency preventing favorable audit opinions is the lack of adequate financial management and feeder systems for compiling accurate and reliable financial data. DoD has implemented three major efforts to improve financial management, the Financial Management Improvement Plan, the Critical Financial and Feeder Systems Compliance Process, and the DoD Implementation Strategies.

DoD Financial Management Improvement Plan. The FMIP was first published in 1998 and is a strategic framework that includes the Department financial management concept of operations that describes the manner in which the Department intends to carry out financial management operations in the future. Progress and improvements have been made in the financial management operations over the past several years; however, much more work remains to be accomplished before the Department can claim a state-of-the-art integrated financial management system. The Department continues to refine the FMIP as evident by the modifications made to the critical financial management systems inventory. In FY 2000, 25 systems were deleted from the critical financial management system inventory, while 24 systems were added, resulting in a net effect of one less than FY 1999 for a total of 167 systems.

Although the FMIP continues to evolve with each issuance, areas remain where modifications could be made to ensure that the FMIP is an accurate and useful tool for enhancing DoD financial management operations and systems. The FY 2000 FMIP still lacks all information required by the Federal Financial Management Improvement Act of 1996 (FFMIA) regarding the funds and timeframes required to correct all system deficiencies. DoD needs to continue identifying all critical financial management systems and providing the full remedies, resources, and intermediate target dates as the DoD Components begin implementation of the Critical Financial and Feeder Systems Compliance Process.

DoD evaluated 53 of the 68 systems identified as long-term critical finance, accounting, and feeder systems. The USD(C) tasked the DoD Components with completing the system evaluations by March 31, 2000, however, those evaluations were not completed. As a result, DoD did not complete the first step in preparing plans to correct deficiencies in financial management systems for 15 critical systems. DoD cannot provide reasonable estimates of the funding or milestones necessary to achieve favorable audit opinions without a complete inventory of systems and specific plans to correct system deficiencies.

Additionally, DoD Components did not conduct proper or complete evaluations of critical financial management systems reported as compliant in the FY 2000 FMIP. DoD did not evaluate financial management systems against FFMIA requirements or did not maintain adequate documentation to support compliance evaluations before reporting systems as FFMIA compliant. As a result, at least 11 of the 19 systems reported as FFMIA compliant, were not FFMIA compliant or the compliance status was not supported.

DoD Critical Financial and Feeder Systems Compliance Process. As approved by the Defense Management Council, the USD(C) developed a financial and feeder systems compliance process dated January 5, 2001, to oversee and monitor the DoD Components' efforts to develop and modify critical finance, accounting, and feeder systems to comply with applicable requirements. The process is patterned after the successful DoD Y2K conversion process and consists of five phases with defined exit criteria. The process includes the designation of a governing body to provide oversight and guidance to the DoD Components on participation and the application of adequate resources.

The goal of the financial and feeder systems compliance process is to ensure that each financial and feeder system complies with Federal financial management requirements. To ensure success of the compliance process, it should include the following:

- accountability measures,
- DoD Component implementation plans,
- non-critical systems feeding data to critical systems,
- flow of data to each financial statement line item, and
- specific information included in tracking the status of each system.

DoD Implementation Strategies. As an interim solution until compliant financial management and feeder systems are in place, DoD was attempting to improve other aspects of its financial management through the development of DoD Implementation Strategies. The implementation strategies are a step towards achieving a favorable audit opinion. The DoD has developed 13 implementation strategies that are in various stages of completion. Three of the implementation strategies have been rebaselined. Five implementation strategies are pending, and five have the implementation in progress. An additional implementation strategy, recommended by the Inspector General, DoD, and subsequently agreed to by the USD(C), is to eliminate unsupported department-level accounting entries and to minimize department-level accounting entries of the data used to compile the DoD Component and DoD Agency-Wide financial statements. This additional strategy has not yet been developed. See Appendix C for the status of the implementation strategies.

DoD Guidance. DoD guidance on intragovernmental eliminations is not in agreement with generally accepted accounting principles. DoD reporting entities are required to report intragovernmental eliminations in the FY 2000 annual financial statements to offset the effect of transactions between:

- a DoD reporting entity and other Federal agencies,
- DoD reporting entities, and
- organizations within a DoD reporting entity.

The DoD guidance did not require adequate support for intragovernmental eliminations. The guidance provided instructions to adjust buyer-side data to agree with seller-side data, without conducting proper research to reconcile the difference. For FY 2000, DoD processed $135.5 billion in unsupported department-level accounting entries to adjust intragovernmental accounts to ensure sufficient balances to cover the amounts needed for elimination. As a result, DoD eliminated $89.5 billion in expenses, $89.5 billion in revenue, $5.9 billion in accounts payables and other liabilities, and $5.9 billion in accounts receivable and other assets in the financial statements that could not be verified.

For FY 2000 reporting, DoD used information from the DoD entity making sales or providing services (“seller-side”) to another DoD entity, or to another Federal agency, that is the recipient and purchaser of those goods or services (“buyer-side”) as the basis for reporting intragovernmental eliminations. DoD presumed that the amounts of intragovernmental accounts receivable, revenue, and advances from others (unearned revenue) reported by the seller were more accurate, and that the corresponding amounts reported by the buyer for intragovernmental accounts payable, expenses, advances, and assets must be adjusted to match the seller records. For example, DFAS processed department-level accounting entries of $14.1 billion to the Army Working Capital Fund, adjusting the amounts in the Army Working Capital Fund to the seller-side data without any research or reconciliation.

DoD accounting systems do not capture trading partner data (data on transactions between DoD and other Federal entities) at the transaction level in a manner that facilitates trading partner aggregations. Therefore, DoD was unable to reconcile intragovernmental revenue balances with its trading partners.

As a result, the DoD Agency-Wide financial statements were at further risk for material misstatements, and the intragovernmental line items were unreliable. The inability of DoD to properly account for and disclose intragovernmental transactions and report trader partner eliminations is a major impediment in obtaining a favorable audit opinion on its financial statements.

Guidance Issued by DFAS. "Journal Voucher Guidance," August 2, 2000, issued by DFAS was not in agreement with generally accepted accounting principles. This guidance established procedures on the use of journal vouchers within the DoD and is retroactive to the beginning of FY 2000. The procedure cited for making accounting entries to intergovernmental accounts does not follow generally accepted accounting principles; consequently, the procedure for supporting these accounting entries is inadequate. In addition, DFAS Centers processed 5,654 unsupported or improper department-level accounting entries, valued at $1.2 trillion. One of the reasons that the department-level accounting entries were unsupported is that they were made to force general ledger data to agree with data from other sources without adequate research and reconciliation.

Risk Assessment

For financial reporting purposes, an entity's risk assessment is its identification, analysis, and management of risks relevant to the preparation of financial statements following generally accepted accounting principles. DFAS Indianapolis has used different locally developed applications to compile the Army General Fund financial statements every year since 1997. This constant change has prevented the development of effective controls over the compilation process.

In addition to the locally developed software, DFAS Indianapolis also used new DFAS-wide applications in FY 1999 (Chief Financial Officer Financial System) and FY 2000 (Defense Department Reporting System). These additional applications added several layers of complexity to the compilation process but have not resulted in either stability in the compilation process or improved internal controls. The changes and increased complexity in the compilation process have increased the risk of material misstatements in DoD financial statements. Control Activities and Information and Communication Control activities are the various policies and procedures that help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Information and communication activities include the accounting system, consisting of the methods and records established to record, process, summarize, and report entity transactions and to maintain accountability of the related assets and liabilities. To be effective, the information and communication system must identify and record all valid transactions; describe transactions on a timely basis; properly measure the value of transactions; record transactions in the proper time period; properly present and disclose transactions; and communicate responsibilities to employees.

Procedural Problems. Procedural problems were primarily related to accounting and reporting procedures and the application of accounting and reporting standards. The FMIP acknowledged procedural problems that existed in DoD.

The published DoD Agency-Wide financial statements for FY 2000 differed materially from the financial statements presented for audit. Table 1 shows the magnitude of these differences for selected statement lines.

Table 1. Comparison of Published Financial with Financial Statements Presented for Audit
(in billions)

Line Item	Amount for Audit*	Published Amount**	Difference	Percent Change
Balance Sheet				
Inventory and Other Related Property	$154.7	$139.1	$(15.6)	-10.12
Environmental Liabilities	52.2	63.2	11.0	21.11
Cumulative Results of Operations	(514.6)	(541.8)	(27.2)	5.29
Statement of Net Cost				
Program Cost with the Public	354.1	365.1	11.0	3.11
Statement of Changes in Net Position				
Net Cost of Operations	336.6	347.5	10.9	3.24
Prior Period Adjustments	56.5	41.3	(15.2)	-26.97
Statement of Financing				
Financing Sources that Fund Costs of Prior Periods	(208.6)	(16.3)	192.3	-92.18

*As of December 22, 2000
**As of February 15, 2001

The DoD should change the financial statements presented for audit only to the extent necessary to record auditor-recommended adjustments. Material changes unrelated to the results of the audit make the financial data contained in the published statements unauditable by any practical means.

Department-Level Accounting Entries. Despite the large volume of department-level accounting entries made to the DoD Component financial data during FY 1999 and FY 2000, some progress had been made. The department-level accounting entries processed to the DoD Components financial data (used to prepare departmental reports and the DoD Agency-wide financial statements for FY 2000) decreased by $3.1 trillion, from at least $7.6 trillion in FY 1999 to at least $4.5 trillion. The department-level accounting entries supported by proper research, reconciliation, and adequate audit trails increased by $200 billion from $2.6 trillion in FY 1999 to $2.8 trillion in FY 2000. The $1.2 trillion of unsupported and improper department-level accounting entries for FY 2000 decreased $1.1 trillion from $2.3 trillion in FY 1999. The major reason for the decrease in unsupported and improper entries was that in FY 1999, DFAS Cleveland made one large entry of $800 billion that did not follow accounting principles. DFAS Cleveland did not make any accounting entries of this magnitude for FY 2000. We did not review $1.8 trillion in accounting entries for FY 1999 and $0.5 trillion in FY 2000.

Although we determined that proper reconciliations were performed and adequate audit trails existed to support $2.8 trillion of the accounting entries, it is important to note that many of these were corrections of errors or resulted from data provided to the DFAS from outside sources that could not be verified through audit. The following table identifies the results of our review of accounting entries made to the DoD Component financial data for FY 2000.

Table 2. Department-Level Accounting Entries for FY 2000
(in billions)

Department-Level Accounting Entries	Supported (entries)	Unsupported (entries)	Improper (entries)	Not Reviewed (entries)	Total (entries)
Army General Fund	$ 103.4 (219)	$ 360.4 (236)	$ 1.1 (4)	$ 0 (0)	$ 464.9 (459)
Army Working Capital Fund	168.2 (174)	36.2 (72)	7.8 (5)	0 (0)	212.2 (251)
Navy General Fund	453.2 (1,103)	81.7 (28)	79.9 (3,342)	397.4 (9,340)	1,012.2 (13,813)
Navy Working Capital Fund	885.9 (432)	48.2 (165)	10.7 (61)	2.5 (316)	947.3 (974)
Air Force General Fund	85.6 (507)	317.4 (1,067)	3.0 (43)	0 (0)	406.0 (1,617)
Air Force Working Capital Fund	68.7 (388)	32.0 (152)	4.3 (8)	0 (0)	105.0 (548)
ODO* General Fund	325.6 (80)	228.0 (377)	0.4 (23)	61.6 (758)	615.6 (1,238)
ODO Working Capital Fund	15.2 (203)	10.0 (66)	0 (0)	0 (0)**	25.2 (269)**
U.S. Army, Corps of Engineers	15.0 (117)	0.3 (5)	0 (0)	15.6 (1,906)	30.9 (2,028)
Military Retirement Fund	687.6 (1)	0 (0)	0 (0)	0 (0)	687.6 (1)
Total	**$2,808.4 (3,224)**	**$1,114.2 (2,168)**	**$107.2 (3,486)**	**$477.1 (12,320)**	**$4,506.9 (21,198)**

*Other Defense Organizations

**The scope of accounting entries reviewed for the ODO Working Capital Fund (WCF) was limited to entries processed by DFAS Indianapolis ($2.5 billion) and DFAS Denver ($22.7 billion). Therefore, the total amount of accounting entries to the ODO WCF financial statements is unknown.

DoD processed at least $4.5 trillion of department-level accounting entries to the DoD Components financial data used to prepare departmental reports and the DoD Agency-wide financial statements for FY 2000. The department-level accounting entries were processed to force financial data to agree with various data sources, to correct errors, and to add new data. Of the $4.5 trillion, proper research, reconciliations, and adequate audit trails supported $2.8 trillion of the department-level accounting entries for FY 2000. However, accounting entries of $1.1 trillion were not supported by adequate audit trails or by sufficient evidence to determine their validity. In addition, department-level accounting entries of $107 billion were improper because the entries were illogical or did not follow accounting principles. We did not review the remaining $477 billion for FY 2000 and, therefore, we did not determine whether they were adequately supported. The magnitude of accounting entries required to compile the DoD financial statements highlights the significant problems DoD has in producing accurate and reliable financial statements with existing systems and processes.

Error Corrections. Error corrections of $588 billion to the DoD Components' financial data affected the amounts reported on the DoD Agency-Wide financial statements for FY 2000. Error corrections decreased in FY 2000 by $14.7 billion from $602.7 billion in FY 1999. Although support existed for these adjustments, DoD can improve the efficiency of the financial statement compilation process and help ensure the integrity of the financial data by improving the accuracy of accounting entries and minimizing the need for error corrections.

Data From Sources Outside DFAS. Data for some reported amounts on the balance sheet were obtained from sources outside of DFAS. Although DFAS had proper support for these accounting entries, the amounts reported could not be verified through audit. The $63.2 billion reported for Environmental Liabilities could not be verified through audit tests because of insufficient controls and inadequate audit trails used by DoD to develop the estimate. In addition, the Assistant Secretary of Defense (Health Affairs) acknowledged that the $192.4 billion reported for the Military Retirement Health Benefits Liability was unreliable.

As a result of these accounting entries, the FY 2000 DoD Agency-Wide Financial Statements were subject to a high risk of material misstatement. The lack of research, reconciliation, and audit trails impaired the auditors' ability to validate the accounting entries. The accounting entries indicate potential problems in DoD financial management systems and processes. Until compliant financial management systems are in place, DoD could improve the accuracy of its financial data by following accounting principles and including the proper support for any accounting entries made to the accounting records. Additional details on these accounting entries and how they compare to the data for department-level accounting entries for FY 1999 will be provided in a separate report.

Fund Balance With Treasury (FBWT). The DoD Components and DFAS did not resolve financial and accounting disparities of $28.4 billion, and the disparities continue to affect the accuracy of the FBWT account. Therefore, we were unable to assess the reliability of the $177.5 billion reported for FBWT on the DoD Agency-Wide financial statements for FY 2000.

The $28.4 billion in disparities (absolute value) include differences ($3.5 billion), unreconciled suspense account balances ($10.2 billion), and disbursement disparities ($14.7 billion). As of September 30, 2000, the U.S. Treasury Financial Management Service reported about $3.5 billion (absolute value) of unreconciled differences to DoD, including differences for deposits ($1.3 billion), interagency transfers ($0.3 billion), and checks issued ($1.9 billion). Furthermore, DFAS reported $10.2 billion of unreconciled suspense account balances for interfund ($1 billion), interagency transfers ($0.8 billion), and differences between net disbursement amounts reported on disbursing stations Statements of Accountability and Statements of Transactions ($8.4 billion). In addition, DoD accounting stations reported $14.7 billion of disbursement disparities including in-transit disbursements ($11.8 billion), unmatched disbursements ($1.7 billion), and negative unliquidated obligations ($1.2 billion).

Army General Fund. Unreconciled differences existed between the official Army report on net disbursements and supporting records. Unreconciled suspense account; expenditure reporting; check issue; deposit; and Online Payment and Collection differences not due to report timing totaled about $848 million at the end of FY 2000. The unreconciled differences represent a material uncertainty in regard to the Fund Balance With Treasury line item balance of $34.5 billion for the Army General Fund.

Army Working Capital Fund. The DFAS Indianapolis FY 2000 Annual Assurance Statement reported internal control weaknesses that affect FBWT for the Army WCF. One internal weakness involved in-transit disbursements, unmatched disbursements, and negative unliquidated obligations. Another internal control weakness involved suspense accounts that require extensive reconciliation to ensure that the accounts are properly used, supported by adequate documentation, timely cleared, and in agreement with U.S. Treasury balances.

Navy Working Capital Fund. DFAS did not perform cash reconciliations between disbursing system records and activity general ledgers and did not retain supporting documentation. Consequently, DFAS managers did not have adequate assurance that Navy WCF account balances for the FBWT were supportable, reliable, and accurate.

Air Force General Fund. DFAS internal controls did not ensure proper matching of disbursements with related obligations, resulting in $60.8 million of negative unliquidated obligations in the accounting systems for the Air Force General Fund. Through electronic commerce initiatives and prevalidation of disbursements, DFAS and Air Force officials continued work in FY 2000 to resolve this long-standing internal control issue.

Air Force Working Capital Fund. DFAS Columbus did not provide supporting documentation for $22.6 million of the $65 million disbursement transactions tested. In addition, DFAS Denver made $4.2 billion in improper and unsupported monthly adjustments and $31.9 billion in improper and unsupported year-end adjustments to Air Force WCF accounting records.

Other Defense Organizations-General Funds. Because accounting offices supporting the Other Defense Organizations do not submit trial balances for all of the Other Defense Organizations entities and sub-entities, DFAS used data from the Reports on Budget Execution to manually create 53 trial balances for 16 entities and sub-entities. The manually created trial balances were not complete because Reports on Budget Execution do not contain financial data for the entire scope of an entity's operations such as accrued annual leave expenses; property, plant, and equipment; and related depreciation. The combined FBWT for the manually created trial balances was $445 million. Additionally, amounts reported for accounts payable and accounts receivable are not reported in separate intragovernmental and public categories as required for the financial statements.

Problem Disbursements. DoD had difficulties with its complex and inefficient payment processes and systems. DFAS has reported progress in reducing in-transit disbursements and problem disbursements. According to DFAS, problem disbursements and in-transit disbursements have been reduced from $12.5 billion (absolute value) in FY 1999 to $4.4 billion (absolute value) in FY 2000. As of September 30, 2000, DoD reported $1.7 billion of unmatched disbursements, $1.2 billion of negative unliquidated obligations and $1.5 billion (absolute value) of in-transit disbursements. The lack of integrated finance and accounting systems caused disbursing stations to make disbursements that were accounted for by stations that were not collocated with the disbursing stations. Unmatched disbursements occurred when the accountable station could not match the disbursement to the correct detail obligation, and negative unliquidated obligations occurred when the disbursement exceeded the amount of the recorded unliquidated obligation. In-transit disbursements occurred when DoD reported a disbursement to the U.S. Treasury, but the disbursement was not received or was not processed by an accountable station. DFAS and the DoD Components have spent considerable time and effort reviewing the causes of problem disbursements and developing actions to eliminate those causes. In addition, the Department has issued more detailed guidance to reduce problem disbursements. Problem disbursements and in-transit disbursements can increase the risks of:

- fraudulent or erroneous payments being made without detection,
- cumulative amounts of disbursements exceeding appropriated amounts and other legal spending limits, and
- inaccurate and unreliable financial reporting.

Further progress in reducing problem disbursements and in-transit disbursements is essential to improve the accuracy and reliability of financial reporting.

Military Retirement Health Benefits Liability. DoD continued to have problems with accurately reporting its military retirement health benefits liability. Outpatient visit data in the Composite Health Care System were unreliable for use in developing the FY 2000 estimate of the military retirement health benefits liability. Outpatient medical care services represented $86 billion of the reported FY 2000 unfunded liability of $192.4 billion. The Assistant Secretary of Defense (Health Affairs) agreed that the data were unreliable and acted by implementing a quality control program to improve the quality of data in time to affect the FY 2001 estimate. Therefore, the FY 2000 estimate of $192.4 billion was based on unreliable data. In addition, the DoD information used to determine the cost of medical care is being reviewed by a DoD working group, which is developing more complete cost information for use in developing the estimate.

Environmental Liabilities. For FY 2000, $63.2 billion reported for DoD Environmental Liabilities could not be verified because of insufficient controls and inadequate audit trails. As a result, the Environmental Liabilities reported on the DoD Agency-Wide financial statements for FY 2000 were unreliable.

Army General Fund. Procedures and controls were not adequate to ensure that reported environmental values were complete and accurate. An environmental restoration liability of $6.7 billion is questionable because supporting documentation does not exist. In addition, the Army does not fully report environmental liabilities for unexploded ordnance on training ranges and national defense equipment disposal costs. Further, where estimated liabilities were disclosed for Formally Used Defense Sites, the Army corrected their financial statement footnotes the week after issuance to remove contingent liabilities of about $103 billion for transferred ranges.

Navy General Fund. The Naval Facilities Engineering Command and the Assistant Secretary of the Navy (Financial Management and Comptroller) did not have adequate procedures and controls to ensure that the amounts reported for environmental liabilities were complete, accurate, or adequately supported. The Navy General Fund had internal control deficiencies related to the accrued restoration costs, Cost-to-Complete Model, and other environmental liabilities.

Air Force General Fund. The Air Force General Fund did not have sufficient time to implement Defense Environmental Restoration Program Supplemental Management guidance, dated August 1999, to correct internal control deficiencies.

System-Related Problems. System-related problems were tied predominantly to weaknesses in DoD financial management systems. The FMIP generally discussed many system-related problems in DoD.

General Property, Plant, and Equipment (PP&E). Although the Military Departments made some improvements in the accounting for and reporting of real property, significant internal controls and system weaknesses still exist that prevent the accurate reporting of the value of real property in DoD. We were unable to verify the $112.5 billion reported for DoD general PP&E because of a lack of supporting documentation. Previously identified problems still exist that affect the accuracy of amounts reported for real property.

- Controls necessary to accurately record additions, deletions, and capital improvements made to real property have not been fully implemented.
- System deficiencies still exist that require management to manually manipulate data to account for real property.
- Personnel responsible for maintaining the real property databases still require training.

Army General Fund. Controls, procedures, and systems to accurately report the value of Army equipment were not adequate. During FY 1999, the Army began fielding the Defense Property Accountability System to meet and comply with financial reporting standards. Because fielding was not completed in FY 2000, the Army used data calls to determine general equipment values and calculate related depreciation. However, the timing of the data call limited the ability to perform the tests necessary to validate the reported value of general equipment on the FY 2000 financial statements. Material misstatements existed that question the reliability and completeness of property book data and value of general equipment reported.

Despite the improvements, the Army had yet to correct the internal control weaknesses related to noncompliance with SFFAS No. 6 and noncompliant systems identified by the Army Audit Agency during the FY 1999 audit. The Assistant Chief of Staff for Installations Management was still developing a policy memorandum to address the internal control issues. Also, the Army needed to correct improper recordings of additions, deletions, or modifications of property and should have developed procedures for identifying and reporting prior period adjustments caused by either inaccurate or late recording of real property assets.

Army Working Capital Fund. During FY 2000, the Army Working Capital Fund activities implemented the Defense Property Accountability System for all of its property, plant, and equipment. The Army believed that the new system provided more reliable values for the balance sheet and depreciation expense for the Statement of Net Cost. As a result of the system implementation, the net book value of property, plant, and equipment was reduced by about $606 million from FY 1999 to FY 2000. The Army Audit Agency could not verify that the reported value (about $1.2 billion or about 9 percent of total assets) for property, plant, and equipment was fairly presented.

Navy General Fund. The Naval Audit Service reported limited improvements in the Navy internal controls on reporting real property in the database. The one improvement involved the scheduled changes to the Navy Facilities Asset Data Base. According to the Navy, the Navy Facilities Asset Data Base information will be available on the web and can be readily accessed and updated. The Navy plans to release a new version of the system (the Internet Naval Facility Asset) shortly. The Navy also changed the ownership of real property from the activity commanding officers to the major claimants. There will be eight major claimants responsible for real property. These activities will report real property changes to the Navy Facilities Asset Data Base via Expanded Access (on-line terminals) or through the engineering field division. The Navy also plans to increase training on the use of the Navy Facilities Asset Data Base/Internet Naval Facility Asset.

Navy Working Capital Fund. Net asset values for general PP&E for supply management were not transaction-based because no wall-to-wall inventory was performed to provide values for each item. Controls over net acquisition, disposals, and capital improvements were not adequate to detect or prevent errors because of management inattention, insufficient staffing, and lack of training.

Air Force General Fund. Within the Air Force, real property personnel at most of the locations visited developed local inventory procedures and schedules for real property. However, the number of facilities inventoried in FY 2000 was not always sufficient to ensure complete, installation-wide inventories within a 5-year period. Real property personnel at most locations retained real property documentation in accordance with Air Force guidance.

Contractor Performance Management System. The USD(C) has directed that the Contractor Performance Management System should not be used to report the $20.5 billion of Government-owned materials held by contractors. This system is not a reliable accounting and reporting system; however, the decision not to use the system excludes $20.5 billion of contractor held material from being reported in the financial statements.

Inventory and Related Property. DoD financial management systems were unable to accurately report amounts for inventory and related property on the DoD Agency-Wide financial statements for FY 2000. The inventory and related property line items consist of inventory, operating materials and supplies, and stockpile materials. Internal controls over inventory were inadequate.

Operating Materials and Supplies. In general, the same problems existed as last year for the FY 2000 DoD financial reporting of operating materials and supplies. Specifically, the Military Departments were unable to implement all elements of Statements of Federal Financial Accounting Standards (SFFAS) No. 3 because of limitations of their financial management processes and systems, including nonfinancial feeder systems. As a result, the Military Departments were unable to value operating materials and supplies at historic cost, did not use generally accepted accounting principles to expense operating materials and supplies, and had not completed the identification of all items that constitute operating materials and supplies. The Military Departments recognized these problems and, as such, qualified the appropriateness of their reported operating materials and supplies balances. Additionally, the Military Departments stated in their financial statements that they were pursuing process and system improvements and addressing the limitations of financial and nonfinancial feeder systems. However, system improvements will not be accomplished for many years. For example, as stated in IG, DoD, Report No. D-2001-014, "Development and Implementation of a Joint Ammunition System," December 6, 2000, the DoD spent 8 years and $41.3 million developing a new system for the logistical and financial reporting of its ammunition inventory. Despite those efforts, DoD did not produce a working system or even have one near completion. Ammunition totaled $43.1 billion for FY 2000 and was a material part of each of the Military Department's reported operating materials and supplies.

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

Navy Working Capital Fund. Net reported values for inventory could not be relied on because no sound sampling plan for measuring the dollar accuracy of reported inventory stored at Government and contractor locations had been implemented. In addition, inventory in-transit from customers and inventory for agency operations (supplies and materiel) could not be verified because Navy Working Capital Fund logistics activities and DFAS Cleveland did not reconcile the general ledger account balances to subsidiary records.

Defense Logistics Agency. The Defense Logistics Agency non-fuel inventory pricing data was inaccurate or unsupported and cannot be relied upon to support the $7.2 billion of non-fuel inventory reported on the Defense Logistics Agency financial statements. Also, the inventory process used by the Defense Logistics Agency to capture and report the cost of its $2.3 billion bulk petroleum product (fuel) inventory was not adequate because of untimely completion and reconciliation of inventories and untimely posting of fuel transactions. Additionally, the logistics and financial systems did not capture the data needed to value year-end inventories at historic cost. For FY 2000, the Defense Logistics Agency contracted with a Certified Public Accounting firm to assess the auditability of its financial statements. The Certified Public Accounting firm has done an exploratory sample related to the $9.5 billion of reported inventory, and they will be making recommendations to improve the sample plans and controls over the inventory.

Required Supplementary Stewardship Information. Stewardship information included National Defense PP&E, heritage assets, stewardship land, non-Federal physical property, and research and development. This information was not required to be audited, and we did not audit the information. The DoD was not in compliance with existing reporting requirements for National Defense PP&E. SSFAS No. 8 requires reporting the value of National Defense PP&E using the latest acquisition cost method. The DoD is reporting National Defense PP&E quantities, condition, and investment trends for major types of National Defense PP&E. The DoD is unable to comply with the existing reporting requirement because many of DoD National Defense PP&E accountability and logistics systems do not contain a value for the National Defense PP&E assets. The Federal Accounting Standards Advisory Board is holding deliberations on various alternatives for reporting National Defense PP&E.

Statement of Net Cost. For FY 2000, the DoD Agency-wide Consolidated Statement of Net Cost reported total intragovernmental program costs of $9.7 billion, total program costs with the public of $365.1 billion, and earned revenues of $27.4 billion. The DoD process for reporting net costs does not capture costs and earned revenues by program cost categories that are consistent with performance goals. Also, the budget basis of accounting is used to prepare the net cost statement, and intragovernmental transaction amounts are not adequately supported. The information in the Statement of Net Cost is not reliable and provides little useful information to the user. DoD recognizes the difficulties in preparing the Statement of Net Cost and has disclosed its departure from accounting standards in its Note to the Principle Statements for FY 2000.

Program Cost Categories. The program categories used for the DoD Agency-wide and DoD Components' Statements of Net Cost were not consistent with the DoD performance goals and measures outlined in the DoD Government Performance and Results Act of 1993 (GPRA) strategic and annual performance plans. DoD guidance incorrectly specified the use of appropriation categories, such as military personnel and operations and maintenance. The appropriation categories were incorrectly specified because DoD did not do the following:

- identify the cost accounting information needed for DoD to establish program categories that were consistent with their GPRA performance plans, or

- have adequate managerial cost accounting systems in place to collect, process, and report operating costs.

DoD has recognized this issue and has made the disclosure in the Notes to the Principle Statements for FY 2000 which state:

> the Department identifies programs based upon major appropriation groups provided by Congress. The Department is in the process of reviewing available data and attempting to develop a cost reporting methodology that balances the need for cost information required by the Statement of Federal Financial Accounting Standard (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," with the need to keep the financial statements from being overly voluminous.

As a result, the DoD Agency-Wide and DoD Components' Statements of Net Cost did not provide cost-of-operations data that were consistent with GPRA performance goals and measures. Without future changes to reporting requirements, reliance on the financial statements would yield limited information related to GPRA.

Basis for Accounting. DoD generally records transactions on a budgetary basis and not on an accrual basis as required by accounting standards. This is particularly true of the accounting for the general funds, which generally record transactions on a cash basis. DoD has disclosed in the Notes to the Principle Statements that information in the Statement of Net Cost was presented on the budget basis. For example, cost information was based on obligation and disbursements as adjusted for payroll accruals and environmental liabilities. As a result, the FY 2000 DoD Agency-Wide Statement of Net Cost may not reflect the full cost of its programs.

Intragovernmental Transactions. Table 3 shows the intragovernmental amounts reported in the FY 2000 DoD Agency-Wide Statement of Net Cost and the supporting Required Supplemental Information schedule. The $89.5 billion in intragovernmental costs and $89.5 billion in intragovernmental revenue eliminations were not reconciled with intragovernmental accounts for buyer and seller transactions. Instead DFAS made $135.5 billion in unsupported department-level accounting entries to intragovernmental and public accounts that were not adequately reconciled in order to adjust the intragovernmental accounts to cover the elimination amounts. DoD did not issue adequate guidance for making eliminating entries. Specifically, DoD guidance provided instructions to adjust buyer-side data to agree with seller-side data, without conducting proper research to reconcile the difference.

Table 3. Intragovernmental Costs and Revenues
(in billions)

Total Program	Combined Totals	Less Eliminations	Consolidated Totals
Intragovernmental Costs	$ 99.2	$89.5	$ 9.7
Earned Revenues	$116.9	$89.5	$27.4*

* Approximately $16 billion of earned revenue was intragovernmental.

Since FY 1996, the Department has been slow to initiate improvements needed to ensure that all of the intragovernmental transactions were captured and the amounts were accurate. In response to prior Inspector General, DoD, audit reports, DoD indicated that it could not perform the critical checks because many of the DoD accounting systems did not capture all the data necessary to reconcile with partners or to accurately identify elimination transactions and balances. As a result, the DoD Agency-wide financial statements continue to contain material misstatements, and the intragovernmental line items are unreliable.

Statement of Financing. DoD does not have the processes and financial systems in place to prepare a reliable Statement of Financing. The Statement of Financing reconciled $454.1 billion of obligations reported on the Statement of Budgetary Resources with the $347.5 billion net cost of operations reported on the Statement of Net Cost of the DoD Agency-Wide financial statements. However, this information was unreliable because DoD made adjustments to force budgetary and proprietary information to agree and did not disclose eliminating entries.

Adjustments to Accounting Information. Budgetary data are not in agreement with proprietary Expenses and Assets Capitalized. This causes a difference in Net Cost of Operations between the Statement of Net Cost and the Statement of Financing. The Statement of Financing, "Costs Capitalized on the Balance Sheet" has been adjusted by a net decrease of $28.6 billion and "Other" has been adjusted by a net decrease of $10.5 billion to make the two statements reconcile. DoD has disclosed these differences between budgetary and proprietary data for the DoD as a previously identified deficiency. The Notes to the Principal Statements stated that DoD would develop alternative procedures to better prepare the Statement of Financing for FY 2001.

Eliminating Entries. The Statement of Financing is presented as combined or combining statements rather than consolidated statements because the intra-equity transactions have not been eliminated. When statements are prepared on a combined basis, the double accounting effects of intra-agency transactions are not removed. OMB Bulletin 97-01 allows the option to prepare the Statement of Financing on a combined or consolidated basis; however, DoD guidance specifies that the Statement of Financing should be prepared on a combined basis. Although DoD has disclosed that the Statement of Financing has been prepared on a combined basis in the Notes to the Principle Statements, the amounts reported are materially overstated and reduce the usefulness of the information reported.

Statement of Budgetary Resources. We were unable to express an opinion on the Statement of Budgetary Resources because of deficiencies in internal controls and accounting systems related to the Statement of Budgetary Resources. The following internal control weaknesses were identified.

Army General Fund. DFAS has not developed a single database for the Army financial statements that contains the detailed transactions supporting the summary transactions used to prepare the Army Reports on Budget Execution and the Army financial statements. Also, problem disbursements remain a significant financial reporting issue for the Army. The DFAS changed its procedure in FY 2000 regarding the recording of contract holdbacks. The Army Audit Agency did not perform detailed audit work in this area during FY 2000, but did determine that DFAS had begun to record contract holdbacks during FY 2000. However, this limited review did not enable the Army Audit Agency to verify the extent of the DFAS corrective action.

Navy General Fund. While problem disbursements do not necessarily represent inappropriate payments, they do have a negative impact on the Navy budget execution and cause delays of vendor payments. Also, in-transit disbursements cause delays in posting disbursements to accounting records. In addition, suspense account balances require extensive reconciliations to ensure that the accounts are properly used, supported by adequate documentation, cleared timely, and in agreement with Department of the Treasury balances. Transactions residing in suspense accounts can conceal problem disbursements.

Air Force General Fund. The process for reporting obligated balances is subject to material weaknesses because transaction records are unavailable and internal controls did not ensure proper matching of disbursements with related obligations. DFAS accounting systems do not maintain individual transaction records of Air Force obligations incurred and recoveries of prior year obligations. Instead, the systems calculate totals for these types of transactions based on net changes in the obligated balances during the period. As a result, no transaction records are available for audit. Moreover, the totals for obligations incurred and recoveries of prior year obligations included on the Statement of Budgetary Resources at $88.2 billion and $1.5 billion, respectively, could be materially misstated because the accounting systems ignore individual increases and decreases which may have contributed to the calculated net change in obligations. Also, the DFAS internal controls did not ensure proper matching of disbursements with related obligations, resulting in $60.8 million of negative unliquidated obligations in the accounting systems. Through electronic commerce initiatives and prevalidation of disbursements, DFAS and Air Force officials continue to work to resolve this long-standing internal control issue.

Air Force Working Capital Fund. DFAS Columbus did not provide supporting documentation for 32 ($22.6 million) of 86 ($65 million) disbursement transactions tested. In addition, Air Force fund managers were not able to provide supporting documentation for 374 ($516.9 million) of 725 ($891 million) open obligation transactions (such as undelivered orders outstanding, accounts payable, unfilled customer orders, and accrued expenses). Also, the Air Force Working Capital Fund accounting systems have not fully implemented the U.S. Government Standard General Ledger at the transaction level for budgetary accounts. Therefore, instead of using budgetary accounts to prepare the Report of Budget Execution, DFAS Denver relied on proprietary and statistical accounts and data not recorded in the accounting records. As a result, the amounts presented in the Statement of Budgetary Resources and the Statement of Financing were not auditable.

Information Security. Security and application controls over financial management systems are critical to ensuring the integrity of data reported on the DoD Agency-Wide financial statements for FY 2000. DoD has become increasingly dependent on automated information systems to carry out its operations and to process, maintain, and report information in the annual financial statements. To date, DoD has identified at least 167 automated systems that process, maintain, and report financial information. We issued three reports and the General Accounting Office issued one report that identified security and application control weaknesses over systems that affected the amounts reported on the DoD Agency-Wide financial statements for FY 2000.

Defense Civilian Pay System. The Defense Civilian Pay System serves more than 704,000 DoD civilian employees and processes transactions valued at $37.5 billion annually. We concluded in IG, DoD, Report No. D-2001-055, "General Controls for the Defense Civilian Pay System," February 21, 2001, that general controls did not provide reasonable assurance of the integrity, confidentiality, and availability of data processed by the Defense Civilian Pay System. We identified 37 weaknesses in establishing an overall security program, controlling access to the system, implementing procedures for developing and changing computer software, establishing policies for proper segregation of duties, and establishing procedures for preventing disruptions in service to customers. As a result, DoD managers may not be able to rely on data processed by the Defense Civilian Pay System or the system's ability to provide reliable data for financial statements. Until corrected, these weaknesses may adversely impact the potential for financial statements that reflect transactions processed by the Defense Civilian Pay System. Further, the weaknesses would cause the financial statements to require substantial additional verification measures. Also, the identified weaknesses may increase the possibility of unauthorized activity taking place without being detected.

Defense Joint Military Pay System. The Defense Joint Military Pay System contains pay files for about 2,265,000 service members and processes more than 6 million payroll transactions monthly, valued at approximately $49 billion annually. We concluded in IG, DoD, Report No. D-2001-052, "Controls Over the Defense Joint Military Pay System," February 15, 2001, that general controls were not effectively providing reasonable assurance of the integrity, confidentiality, and availability of data processed by the Defense Joint Military Pay System. We identified weaknesses in limiting access to the system, establishing controls to monitor the use of the system's software, establishing an overall security program, implementing procedures for developing and changing computer software, and establishing procedures for preventing disruptions in service to customers. Weak controls had allowed almost 20,000 security violations to remain uninvestigated. In addition, the Defense Information Systems Agency had identified significant deficiencies in controls over the system that adversely impacted the accessibility, reliability, and security of the system. More than 70 percent of those deficiencies remained uncorrected after more than a year. As a result, DoD managers may not be able to rely on data that the Defense Joint Military Pay System processed or the system's ability to provide reliable data for financial statements. The general control weaknesses identified will adversely affect obtaining a favorable audit opinion until corrected. Also, the identified weaknesses could increase the possibility for unauthorized activity to occur and not be detected in a timely manner.

Integrated Accounts Payable System. Annually, the DFAS uses the Integrated Accounts Payable System to make approximately 1.2 million vendor payments, valued at $16.5 billion, for Air Force customers. We concluded in IG, DoD, Report No. D-2000-139, "Controls Over the Integrated Accounts Payable System," June 5, 2000, that controls over the Integrated Accounts

Payable System did not effectively prevent unwarranted and unauthorized system access and ensure adequate audit trails. As a result, the Integrated Accounts Payable System vulnerabilities were not minimized, and individuals might be able to circumvent prompt payment interest requirements.

U.S. Army Corps of Engineers' Systems. In FY 2000, the U.S. Army Corps of Engineers' systems accounted for about $39.7 billion in total assets and $10.6 billion in total budgetary resources. The General Accounting Office identified weaknesses in the U.S. Army Corps of Engineers' computer controls at its data processing centers. Other Corps of Engineers' sites revealed serious vulnerabilities that would allow both hackers and numerous legitimate users with valid access privileges to improperly modify, inappropriately disclose, and destroy sensitive and financial data. The General Accounting Office noted "serious general control weaknesses impaired the Corps of Engineers' ability to protect computer resources, limit access to computer programs and files, control powerful systems software, ensure that only authorized programs were placed in operation, and enforce proper segregation of duties."

The General Accounting Office also identified significant application control weaknesses related to the authorization and recertification of access, updates to the access control table, the assignment of responsibilities, and the assignment and protection of electronic signature cards. These weaknesses could, for example, result in:

- user activity that is not consistent with Corps of Engineers security objectives, management's authorized intent, or user job responsibilities,
- fraudulent financial reporting, such as the misuse of inventory adjustments, labor cost transfers, and general ledger transactions,
- a single individual gaining control of a transaction from initiation to completion, and
- an individual entering a fraudulent transaction in the financial system, such as by accessing an unattended terminal with an electronic signature card left in the reader and attributing that transaction to another user.

These general and application control weaknesses impair the ability of the U.S. Army Corps of Engineers' to ensure the confidentiality and availability of data contained in the financial system.

Monitoring

Monitoring assesses the quality of internal control performance over time and involves assessing the design and operation of controls on a timely basis and taking the necessary corrective actions. Monitoring activities are accomplished through ongoing activities, separate evaluations, or a combination of the two.

DoD conducted significant monitoring activities during FY 2000. DoD continued to revise the Financial Management Improvement Plan (FMIP) and the Implementation Strategies to identify and address financial management problems and the remedies in place to correct financial management practices and systems. DoD made progress in implementing the FMIP and the Implementation Strategies. However, DoD must continue to revise and improve these efforts to ensure that progress continues toward improved financial management.

We identified areas where DoD could improve its monitoring activities related to the preparation of the DoD Agency-Wide financial statements for FY 2000. We determined that a primary cause of inconsistent, inaccurate, and incomplete reporting was the inability of DoD to perform adequate reviews and reconciliations while preparing the financial statements. As previously discussed, we identified $1.2 trillion in unsupported or improper department-level accounting entries that affected amounts reported on the DoD Agency-Wide financial statements for FY 2000. Many of these entries were the result of inadequate reviews and reconciliations. Reviews and reconciliations are a key monitoring activity that help to identify problems in financial management and reporting. Implementation and consistent use of reviews and reconciliations will improve the ability of DoD to identify and solve problems and produce auditable financial statements.

Assessment of Fraud Risk

SAS No. 82 requires us to specifically assess the risk of material misstatement of the DoD Agency-Wide financial statements for FY 2000 due to fraud, and to consider that assessment in designing audit procedures to be performed. SAS No. 82 describes two types of fraud that are relevant to the auditors' consideration of fraud in a financial statement audit: misstatements arising from fraudulent reporting and misstatements arising from misappropriation of assets. Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Misstatements arising from misappropriation of assets involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented in conformity with generally accepted accounting principles. For each of the two types of fraud, SAS No. 82 identifies fraud risk factors that auditors should consider.

Risk Factors for Fraudulent Financial Reporting

Risk factors for fraudulent financial reporting included:

- motivation for management to engage in fraudulent financial reporting;
- failure of management to display and communicate an appropriate attitude regarding internal controls and the reporting process;
- excessive participation by nonfinancial management in selecting accounting principles or determining significant estimates;

- assets, liabilities, revenues, and expenses based on significant estimates that involved unusually subjective judgments or uncertainties; and

- significant, unusual, or highly complex transactions or adjustments, especially those close to year's end, that posed difficult questions.

Based on our financial audits, we determined that many of the fraudulent financial reporting risk factors were present within DoD. For example:

- DFAS processed substantial unsupported year-end accounting entries to prepare and ensure consistency in DoD financial statements.

- DoD reporting entities were unable to provide auditors with adequate audit trails linking financial statement data to supporting transaction-level data.

- DoD reporting entities were unable to demonstrate adequate accounting control over DoD assets.

- DoD financial management processes and systems and controls were not adequate.

These examples are discussed in greater detail in this report in the section on Control Environment and the section on Control Activities and Information and Communication.

The presence of these risk factors did not necessarily indicate fraudulent financial reporting. However, the presence of these risk factors in DoD, combined with the fraud investigations conducted by the Defense Criminal Investigative Service, indicated an increased level of risk of material misstatements and that the control environment in DoD was susceptible to fraudulent financial reporting. The existence of many of these fraud risk factors was due to the fact that financial reporting in DoD is an evolving process. DoD is adapting many existing nonfinancial procedures and systems to fulfill more stringent financial management and reporting requirements.

Risk Factors for Misappropriation of Assets

Risk factors for misappropriation of assets included:

- large amounts of cash on hand or processed;

- inventory characteristics, such as small size, high volume, or high demand;

- lack of appropriate management oversight;

- inadequate recordkeeping;

- lack of appropriate segregation of duties or independent checks;

- lack of an appropriate system for authorization and approval of transactions;
- poor physical safeguards over assets; and
- lack of timely and appropriate documentation for transactions.

All audits conducted by the IG, DoD, include steps to provide reasonable assurance of detecting fraud or other illegal acts. Any suspected instances of fraud or other illegal acts are coordinated with the Defense Criminal Investigative Service. Most of these referrals involve misappropriation of assets. In FY 2000, the Defense Criminal Investigative Service initiated 156 cases that involved DoD financial operations and at the end of FY 2000 had 370 open cases that involved DoD financial operations.

We were unable to determine the effects of these fraud investigations on the DoD Agency-Wide financial statements for FY 2000. However, these investigations demonstrated that DoD was vulnerable to misappropriation of assets. This is particularly true for DoD contractors or DoD employees with malicious intent. Their knowledge of systemic weaknesses in DoD would make it easier for them to commit and disguise inappropriate actions.

Conclusion

Although progress has been made, DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that accounting entries impacting financial data were fully supported and that assets, liabilities, costs, and budget resources were properly accounted for and reported. DoD financial reporting guidance was inadequate and DoD did not provide the financial statements to the auditors in a timely manner. These problems are not new but are recurring problems that DoD needs to address and correct.

The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-Wide financial statements for FY 2000, the DoD Components' Annual Statements of Assurance for FY 2000, and the DoD FMIP.

Review of Compliance With Laws and Regulations

Reportable Noncompliances

Reportable instances of noncompliance are failures to follow requirements, laws, or regulations that cause us to conclude that the aggregation of the misstatements resulting from those problems is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant.

Our objective was to assess the compliance with laws and regulations related to the DoD Agency-Wide financial statements for FY 2000 and not to express an opinion. Therefore, we do not express an opinion on compliance with laws and regulations. DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. We identified noncompliance issues related to the Federal Financial Management Improvement Act of 1996 (FFMIA); the Chief Financial Officers Act of 1990 (CFO); Section 3512, Title 31, United States Code; laws governing the claims of the United States Government; and the GPRA.

Federal Financial Management Improvement Act of 1996

Under the FFMIA, we are required to report whether the agency's financial management systems substantially comply with Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger (USGSGL) at the transaction level. We performed our review on FFMIA in accordance with OMB memorandum "Revised Implementation Guidance for the Federal Financial Management Improvement Act," January 4, 2001.

The results of our tests disclosed instances where the agency's financial management systems did not substantially comply with the three requirements. The Military Departments, Defense agencies, and DFAS are collectively responsible for the financial management systems that support DoD. The Military Departments and Defense agencies are responsible for the mixed data systems. These data are fed into the accounting and finance systems that are the responsibility of DFAS. DFAS used data from the financial management systems and other sources to compile the DoD Agency-Wide financial statements for FY 2000. DoD identified at least 167 systems that were critical to financial management. Because it is impractical to report the deficiencies for all 167 systems, this report gives examples of the most significant system deficiencies.

- The DoD FMIP identified 34 critical finance, accounting, and feeder systems that do not comply with FFMIA. The noncompliant critical finance, accounting, and feeder systems in the FMIP are identified in Appendix D.

- We identified an additional 11 critical finance, accounting, and feeder systems that may not be compliant with the FFMIA although they were reported as compliant in the DoD FMIP.

Federal Financial Management System Requirements. Federal financial management system requirements were established in OMB Circular No. A-127, "Financial Management Systems," July 23, 1993, which requires financial management systems to provide complete, reliable, consistent, timely, and useful information. To achieve this goal, DoD and other Federal agencies must establish and maintain a single, integrated financial management system. In addition, the Joint Financial Management Improvement Program published a series of "Federal Financial Management System Requirements" that establishes standard requirements for Federal agencies' integrated financial management systems. For FY 2000, the financial management systems that support DoD did not substantially comply with Federal financial management system requirements, as shown by the following.

- DoD did not have an integrated financial management system.

- The DFAS Indianapolis (Sustaining Forces) did not employ an integrated financial management system for departmental financial reporting. The DFAS Indianapolis (Sustaining Forces) used the Program Budget Accounting System to account for funding, the "TI [Treasury Index] 97 Application" to prepare Reports on Budget Execution, miscellaneous systems to report on expenditures, and an entirely separate set of systems for compilation.

- Systems supporting the Air Force WCF did not provide adequate application controls to critical Air Force feeder systems such as separation of duties, support for transactions, transaction controls, and data reconciliation.

- Air Force and DFAS financial management systems did not maintain adequate subsidiary records for audit trails.

- The FMIP did not include all financial management systems that supported the Army WCF.

Federal Accounting Standards. Federal agencies are to follow the SFFASs agreed to by the Director, OMB; the Comptroller General of the United States; and the Secretary of the Treasury. Currently, there are 18 SFFASs and 3 Statements of Federal Financial Accounting Concepts (SFFAC). For FY 2000, the financial management systems that supported DoD did not substantially comply with Federal accounting standards, as shown by the following:

- DoD financial management systems did not properly account for assets and liabilities in accordance with SFFAS No. 1.

- DoD financial management systems did not value inventory in accordance with SFFAS No. 3.

- DoD financial management systems did not accumulate costs for major programs in accordance with SFFAS No. 4.

- DoD financial management systems did not value PP&E in accordance with SFFAS No. 6.

- DoD financial management systems did not recognize revenue in accordance with SFFAS No. 7.

- The financial reporting process and financial statements did not comply with SFFAC No. 1 because $89.5 billion of differences between trial balances and Reports on Budget Execution were not reconciled. These differences existed because an integrated financial management system for departmental financial reporting was not employed.

USGSGL at the Transaction Level. The OMB requires Federal agencies to implement the USGSGL in their financial systems. The USGSGL must be implemented at the transaction level. Federal agencies are permitted to supplement their application of the USGSGL to meet agency-specific information requirements. However, agency standard general ledgers must maintain consistency with the USGSGL. For FY 2000, DoD finance and accounting lacked a standard, transaction-driven general ledger because the USGSGL was not fully implemented throughout the systems.

DoD has acknowledged that its financial management systems have significant procedural and systemic deficiencies. DoD has included a discussion of those deficiencies in previous Annual Statements of Assurance, the management representation letter for the DoD Agency-Wide financial statements for FY 2000, and the FMIP.

Chief Financial Officers Act of 1990

The CFO Act, 31 U.S.C. 501, as amended by the Federal Financial Management Act of 1994, required DoD to prepare audited financial statements and submit them to OMB no later than March 1, 2001. In addition, the CFO Act required DoD to prepare a Five-Year Financial Management Plan describing activities that DoD will conduct during the next 5 years to improve financial management. The financial statements we received for FY 2000 were unauditable. The FMIP addressed the requirement in the CFO Act for a Five-Year Financial Management Plan.

Section 3512, Title 31, United States Code

The evaluation and reporting requirements of the Federal Managers' Financial Integrity Act of 1982 for an agency's internal accounting and administrative control systems were incorporated in 31 U.S.C. 3512. That section requires DoD to evaluate the systems and to annually report whether those systems are in compliance with 31 U.S.C. 3512. DoD fulfilled part of 31 U.S.C. 3512 requirement by including the discussion of financial management system deficiencies, usually published as part of the Annual Statement of Assurance, in its FMIP. The DoD Components' Annual Statements of Assurance and the FMIP discussed systemic and nonsystemic internal control weaknesses. However, as previously discussed, DoD has not completed its evaluation of all the finance, accounting, and feeder systems that have been identified for long-term use. Therefore, DoD was unable to completely report all system weaknesses.

The USD(C) implemented a new Financial and Feeder Systems Compliance Process in January 2001 patterned after the DoD successful "Y2K" process to ensure that each critical system is compliant with applicable Federal financial management requirements. Each critical system will be shown in one of five phases: awareness, evaluation, renovation, validation, and compliance. The process established a Senior Financial Management Oversight Council and a supporting working group to provide oversight, monitoring, approval, and verification of the status of each system and ensure exit criteria for each phase has been fulfilled. This process will help ensure that senior DoD officials are aware of both the importance of having compliant systems and the status of each critical system. We support this initiative, and DoD auditors will be participating in the Validation Phase to verify the existence of adequate documentation to support management's certification that each system is compliant.

Provisions Governing Claims of the United States Government

Public Law 89-508, "Federal Claims Collection Act of 1966," (codified as 31 U.S.C. 3711(a)(1) requires DoD to attempt to collect all claims of the United States for money or property arising out of DoD activities or activities referred to DoD. Public Law 97-365, "Debt Collection Act of 1982," (codified as 31 U.S.C. 3716 and 3717) allows DoD to collect a claim by means of administrative offset within 10 years, to charge a minimum annual rate of interest on outstanding debts, and to assess charges to cover the costs of processing and handling delinquent claims. Additionally, Public Law 104-134, "Debt Collection Improvement Act of 1996," (codified as 31 U.S.C. 3711(g)(1)(A)) requires DoD to transfer to the Treasury Department any debts delinquent for at least 180 days. The Treasury Department is then responsible to either collect the debt or to terminate collection actions on the debt or claim.

During FY 2000, our audit of the debt collection process showed that DoD had 204 open debts totaling $47.2 million with 37 large DoD contractors, some of which have remained open since the mid-1980s. Our validation of these claims showed that 38 claims valued at $9 million were apparently invalid or had apparently lapsed. Debts remained open for these DoD contractors because DoD did not identify all debts in a timely manner and did not actively work to collect or resolve these debts. As of May 31, 2000, DoD had not collected $38.2 million in contractor debt for large DoD contractors. DoD has 10 years to collect debts before they expire. The collection period remaining on these debts range from 3 months to 9 years. In addition, if DoD corrects the internal control weaknesses identified, additional debts will be collected.

Government Performance and Results Act of 1993

The GPRA, 31 U.S.C. 1101, was enacted primarily to improve the confidence of the American people in the capability of the Federal Government by systematically holding Federal agencies accountable for achieving program results. GPRA requires that each Federal agency prepare a strategic plan and annual performance plans and reports. DoD has prepared the strategic and performance plans that included two DoD corporate-level goals and seven performance goals contained in the FY 2000 DoD GPRA performance plan. An additional objective to "Improve DoD financial and information management" was added in the FY 2001 DoD GPRA performance plan. The "Improve DoD financial and information management" goal included two financial management relevant performance measures. Measure 2.5.1. was to reduce the number of noncompliant accounting and financial management systems to seven for FY 2000. Measure 2.5.2. was to achieve an unqualified opinion on one financial statement for FY 2000. Although DoD achieved the one unqualified opinion, the Military Retirement Fund financial statements, it did not achieve its goal of seven noncompliant accounting and finance systems.

DoD tracks its progress in reducing the number of noncompliant systems through the DoD FMIP. The FY 2000 FMIP reported 11 noncompliant accounting and finance systems. Table 4 shows a comparison of the performance goal and the number of reported noncompliant systems.

Table 4. Comparison of Measure and Performance for Reducing the Number of Noncompliant Accounting and Finance Systems

Type of System	Number per Performance Measure	Number per FY 2000 FMIP	Short of (Excess) of Goal
Accounting	5	10	5
Finance	2	1	(1)
Totals	**7**	**11**	**4**

The number of noncompliant accounting and finance systems reported by DoD in the FY 2000 FMIP does not include 51 legacy systems. Legacy systems are accounting and finance systems that are still being used, but have not been evaluated for FFMIA compliance and that DoD plans to eventually eliminate or replace. The FMIP also reported that there were 23 feeder systems that were not compliant. The DoD performance measure does not include feeder systems although feeder systems are critical to DoD accounting and reporting financial information.

In addition, the compliance status of systems reported in the DoD FMIP the number of reported compliant accounting and finance systems is inaccurate. Specifically, 3 finance and 4 accounting systems reported as compliant were either not compliant or the compliance status was not supported.

OMB Bulletin No. 97-01, as amended, requires that DoD include GPRA-related information in the financial statements, specifically:

- the Overview section of the DoD Agency-Wide financial statements is to contain a discussion of GPRA performance measures and is to provide a link between those performance measures and the programs presented in the Statement of Net Cost, and

- the program cost categories reflected in the Statement of Net Cost should be consistent with the DoD GPRA Performance Plan as published in the Annual Defense Report.

Financial Statement Overview. The Overview section of the FY 2000 DoD Agency-Wide Financial Statements identified and discussed GPRA performance measures relevant to DoD as required by OMB Bulletin No. 97-01. This discussion included the two DoD corporate-level goals and seven performance goals contained in the FY 2000 DoD GPRA performance plan and the additional objective to "Improve DoD financial and information management" from the FY 2001 DoD GPRA performance plan. Under the "Improve DoD financial and information management" objective, the Overview section states that DoD has reduced the number of finance and accounting systems from 324 in FY 1991 to 76 in FY 2000 and has achieved unqualified opinions on the Military Retirement Fund financial statements since FY 1995. The performance measures discussed in the Overview do not have to be identical; however, OMB No. 97-01 does require the Overview to be consistent with measures included in GPRA documents and linked to programs in the Statement of Net Cost. However, the FY 2000 Overview section does not provide DoD managers and other financial statement users with a link between financial data in the Statement of Net Cost and the GPRA performance goals and measures. The DoD Financial Management Regulation, was amended in December 2000, and now states that the Overview will contain discussion of performance goals contained in the Strategic plan consistent with the Statement of Net Cost. This should facilitate the Departments compliance with OMB Circular No. A-11, which also requires actual performance data for selected key performance goals.

Program Cost Categories. The program cost categories used for the Statement of Net Cost and the DoD performance goals and measures outlined in the DoD GPRA performance plan are not consistent. Consistency is essential to ensure there is a link between program costs and performance goals and measures. The Statement of Net Cost identifies programs based on the nine major appropriation categories provided by Congress. Using these appropriation categories as programs does not meet the intent of SFFAS No. 4 which requires that consistent cost data, drawn from a common source, support both performance measurement and financial reporting. Because the DoD programs are not consistent, we continue to believe it is important that the USD(C) work with the major CFO and GPRA participants within DoD to ensure that meaningful cost programs are developed that are based on meaningful performance goals. Until these specific cost accounting requirements have been identified and developed, it will be difficult for DoD to develop accounting systems that will provide meaningful cost information that can be tied to GPRA goals. As a result, Congress, DoD managers, and other users of the DoD financial statements are not able to compare net cost-of-operations data provided in the Statement of Net Cost with performance achievements and shortfalls.

Conclusion

Noncompliance with laws and regulations affected the DoD Agency-Wide financial statements for FY 2000. Many noncompliance issues were related to deficiencies in financial management systems and may not be fully corrected for a number of years. Other noncompliance issues were not specifically related to system deficiencies and should be correctable in the near future. All instances of noncompliance, including those not identified in this report, should be identified and addressed in the FMIP and related supporting documents, and DoD should plan for proper corrective actions. Improvement in compliance with laws and regulations is essential for DoD to improve financial management and reporting and will enhance the ability of DoD to achieve a favorable audit opinion. We reported similar instances of noncompliance with laws and regulations for the audit of the FY 1999 financial statements.

Appendix A. Audit Process

Scope

Statements Reviewed. We examined the DoD Agency-Wide financial statements for FY 2000, the footnotes to the financial statements, the Overview, Required Supplemental Stewardship Information, and Required Supplemental Information. The financial statements consist of the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, Statement of Financing, and Statement of Custodial Activity.

Scope Limitation. The CFO did not provide sufficient or reliable information for us to evaluate management's assertions or verify amounts on the DoD Agency-Wide financial statements for FY 2000. Because of the deficiencies in the accounting system and internal controls, the scope of our work was not sufficient to allow us to render an opinion on the DoD Agency-Wide financial statements for FY 2000. To report on the internal controls and compliance with laws and regulations, we relied in part on audit work conducted by the Military Department audit agencies (the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency) and the General Accounting Office. Our combined audit efforts provide a reasonable basis for our results.

Accounting Principles. Accounting principles and standards for the Federal Government have been established and are under continuous development and refinement. The Federal Accounting Standards Advisory Board was established by OMB, the U.S. Department of the Treasury, and the General Accounting Office. On October 19, 1999, the American Institute of Certified Public Accountants recognized the Federal Accounting Standards Advisory Board as the body that establishes generally accepted accounting principles for Federal Government entities. Therefore, SFFASs issued by the Federal Accounting Standards Advisory Board are recognized as generally accepted accounting principles for applicable Federal Government entities.

Agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, as amended. The hierarchy is as follows: standards agreed to and published by the Director, OMB, the Secretary of the Treasury, and the Comptroller General of the United States; interpretations of SFFAS issued by OMB; requirements for the form and content of financial statements outlined in OMB Bulletin No. 97-01, as amended; and accounting principles published by other authoritative sources.

Review of Internal Controls. In planning and performing our audit, we considered DoD internal controls over financial reporting by obtaining an understanding of the agency's internal controls. We determined whether the controls had been placed in operation; we assessed control risk; and we performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. Our purpose was not to provide assurance on internal controls over financial reporting. Consequently, we did not express an opinion on DoD internal controls.

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls. Because of DoD material weaknesses in internal controls, we revised our audit approach to focus on specific internal controls. We obtained an understanding of management's process for evaluating and reporting on the internal controls and accounting systems and compared the material weaknesses in financial reporting, to the material weaknesses and reportable conditions we identified. A copy of this report will be provided to the USD(C), who is the senior official in charge of management controls for DoD.

We performed a review of the performance information presented in the Overview of the DoD Agency-Wide financial statements for FY 2000. We obtained an understanding of the internal controls related to assertions about the existence and completeness of assets and determined whether they were placed into operation. We also reviewed the preparation of the performance information relating to the summarization and reporting of performance measure information in conformance with OMB Bulletin No. 97-01, as amended.

Review of Compliance With Laws and Regulations. DoD management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the DoD Agency-Wide financial statements for FY 2000 were free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations. A reportable noncompliance could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in the OMB Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," dated October 16, 2000. Our review also included the requirements referred to in the FFMIA. See Appendix B for a list of laws and regulations reviewed.

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-2)**

- **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 Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

* **Financial Management Functional Area. Objective:** Consolidate finance and accounting operations. **Goal:** Consolidate and standardize financial systems. **(FM-2.1)**

* **Financial Management Functional Area. Objective:** Consolidate finance and accounting operations. **Goal:** Reduce and improve accounting systems. **(FM-2.2)**

* **Financial Management Functional Area. Objective:** Eliminate problem disbursements.

  * **Goal:** Reduce problem disbursements by over 60 percent. **(FM-3.1)**

  * **Goal:** Improve the processing and control over cross-disbursements. **(FM-3.2)**

  * **Goal:** Improve timeliness and accuracy of obligations. **(FM-3.3)**

* **Financial Management Functional Area. Objective:** Reengineer DoD business practices.

  * **Goal:** Standardize, reduce, clarify, and reissue financial management policies. **(FM-4.1)**

  * **Goal:** Improve data standardization of finance and accounting data items. **(FM-4.4)**

* **Financial Management Functional Area. Objective:** Strengthen internal controls. **Goal:** Improve compliance with 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.

Methodology

Auditing Standards. We conducted this financial statement audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD, and the OMB Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements." Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal statements present fairly, in all material respects, and in conformity with Federal accounting standards, the assets, liabilities, and net position; net costs; changes in net position; budgetary resources; reconciliation of net costs to budgetary obligations; and if applicable, custodial activity. To assess the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses, we relied on the guidelines suggested by the General Accounting Office and on our professional judgment.

Audit Assistance. The Military Department audit agencies assisted us by auditing various reporting entities and accounts. Except for deficiencies unique to the consolidation process, the information in this report is a summary of the most significant issues reported by the IG, DoD, the Military Department audit agencies, and the General Accounting Office.

Computer-Processed Data. We could not rely on the computer-processed data used to prepare the DoD Agency-Wide financial statements for FY 2000. DoD financial management systems were unreliable; therefore, the financial statements were unauditable. DoD has candidly addressed deficiencies in its financial management systems in the DoD Components' Annual Statements of Assurance, the FMIP, and the DoD management representation letter for FY 2000. Unreliable computer-processed data were used in preparing the financial statements and this report because they were the only financial data available. We continue to review the adequacy of existing and proposed financial management systems.

Statistical Sampling Methods. We relied on information in audit reports and summaries and in management reports. We did not use statistical sampling methods.

Audit Period and Locations. We performed this financial statement audit from October 2000 through February 2001 at various DoD activities, including DFAS and the Military Departments.

Representation Letters. We received the management representation letter from the USD(C) on February 15, 2001, and the legal representation letter from the General Counsel, DoD, on February 6, 2001. Exhibit 1 is the management representation letter and Exhibit 2 is the legal representation letter.

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

Prior Coverage

The GAO and the IG, DoD, have conducted multiple reviews related to financial statement issues. GAO reports can be accessed on the Internet at http://www.gao.gov. IG, DoD, reports can be accessed on the Internet at http://www.dodig.osd.mil.

Appendix B. Laws and Regulations Reviewed

Antideficiency Act (sections 1341(a)(1)(A) and (C), and section 1517(a), title 31, United States Code)

Pay and Allowance System for Civilian Requirements (section 5332 and 5343, title 5, United States Code; and section 206, title 29, United States Code)

Public Law 106-65, "National Defense Authorization Act for FY 2000," October 5, 1999

Public Law 104-208, "Federal Financial Management Improvement Act of 1996," September 30, 1996

Public Law 104-134, "Debt Collection Improvement Act of 1996," April 26, 1996 (section 3711(g)(1)(A), title 31, United States Code)

Public Law 103-356, "Federal Financial Management Act of 1994," October 13, 1994 (this Act may also be cited as the "Government Management Reform Act of 1994")

Public Law 103-62, "Government Performance and Results Act of 1993," August 3, 1993

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990 (section 501, title 31, United States Code)

Public Law 101-508, "Federal Credit Reform Act of 1990," November 5, 1990, (section 661(b) and (e), title 2, United States Code)*

Public Law 97-365, "Debt Collection Act of 1982," October 25, 1982, (sections 3701(a)(1), 3716, 3717, title 31, United States Code)

Public Law 97-255, "Federal Managers' Financial Integrity Act of 1982," September 8, 1982 (section 3512, title 31, United States Code)

Public Law 97-177, "Prompt Payment Act," May 21, 1982, (sections 3901(a), (b), and (f), and 3904, title 31, United States Code)

Public Law 89-508, "Federal Claims Collection Act of 1966," July 19, 1966, (section 3711(a)(1), title 31, United States Code)

OMB Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," October 16, 2000

OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended

* The provisions of the Federal Credit Reform Act of 1990 do not materially impact the Department of Defense.

OMB Memorandum “Revised Implementation Guidance for the Federal Financial Management Improvement Act,” January 4, 2001

DoD Directive 5010.38, “Management Control (MC) Program,” August 26, 1996

DoD Regulation 7000.14-R, “DoD Financial Management Regulation,” various dates

Appendix C. Status of Implementation Strategies

Implementation Strategy	Status			
	Rebaselined	Pending	Implementation in Progress	Not Developed
General PP&E[1]: Existence and Completeness (Excludes Property in the Hands of Contractors)	X			
General PP&E[1]: Valuation of Real Property and Personal Property	X			
General PP&E[1]: Government Property in the Possession of Contractors	X			
PP&E[1]: Deferred Maintenance		X		
Inventory: Existence, Completeness, and Valuation in Possession of DoD		X		
Operating Materials and Supplies: Existence, Completeness, and Valuation in Possession of DoD[2]		X		
Inventory and Operating Materials and Supplies: In the Possession of Contractors		X		
Liability Issues: Environmental Restoration Liabilities			X	
Liability Issues: Hazardous Waste (Environmental Disposal) Liabilities			X	
Liability Issues: (Nonenvironmental) Disposal Liabilities			X	
Liability Issues: Postretirement Health Care Liabilities			X	
Fund Balance With Treasury			X	
Intragovernmental Eliminations		X		
Department-level Accounting Entries				X
Total	3	5	5	1

[1] Property, Plant, and Equipment
[2] The Implementation Strategy for Ammunition and Munitions was incorporated into the Operating Materials and Supplies Implementation Strategy.

Appendix D. Noncompliant Critical Finance, Accounting, and Feeder Systems

System Name	System Acronym	System Function	Owner
Acquisition and Due-In System[3]	ADIS	Acquisition	Air Force
Air Force Equipment Management System[3]	AFEMS	Property Management	Air Force
Aircraft Engine Management System[3]	AEMS	Property Management	Navy
Aircraft Inventory Readiness and Reporting System[3]	AIRRS	Property Management	Navy
Airlift Services Industrial Funds Integrated Computer System[3]	ASIFICS	Cost Management	Air Force
AMARC Business System[3]	ABS	Cost Management	Air Force
Asset Tracking Logistics and Supply System Phase II+[3]	ATLASS II+	Inventory Management	Navy
Automated Civil Engineering System-Real Property[3]	ACES-RP	Property Management	Air Force
College and University Financial System[2]	CUFS	General Funds	TRICARE Management Activity
Commodity Command Support System[2]	CCSS	Defense Working Capital Funds	DFAS
Comprehensive Engine Management System[3]	CEMS	Property Management	Air Force
Conventional Ammunition Integrated Management System[3]	CAIMS	Property Management	Navy
Craft and Boat Support System[3]	CBSS	Property Management	Navy
Defense Cash Accountability System[2]	DCAS	Cash Accountability	DFAS
Defense Transportation Payment System[1]	DTRS	Transportation Payment	DFAS

Note: See footnotes at the end of the appendix.

System Name	System Acronym	System Function	Owner
Facility Inventory Planning System[3]	FIPS	Property Management	Navy
Financial Management Information System[2]	FMIS	General Funds	Navy
General Accounting and Reporting System[2]	GAC	General Funds	National Security Agency
Industrial Logistics Support Management Information System[3]	ILSMIS	Inventory Management	Navy
Job Order Cost Accounting System II[3]	JOCAS II	Cost Management	Air Force
Military Sealift Command Financial Management System[2]	MSCFMS	Defense Working Capital Funds	Navy
Naval Vessel Register[3]	NVR	Property Management	Navy
On-Line Vehicle Interactive Management System[3]	OLVIMS	Cost Management	Air Force
Reliability and Maintainability Information System[3]	REMIS	Property Management	Air Force
Reserve Integrated Management System (Financial Management)[3]	RIMS (FM)	Cost Management	Navy
Shipyards Management Information System[2]	SYMIS	Defense Working Capital Funds	Navy
Standard Accounting and Reporting System[2]	STARS	General Funds	DFAS
Standard Base Supply System[3]	SBSS	Inventory Management	Air Force
Standard Industrial Fund System[2]	SIFS	Defense Working Capital Funds	DFAS
Standard Material Accounting System[2]	SMAS	Defense Working Capital Funds	DFAS
Stock Control System-Recoverable Assembly Management Process[3]	SCS-RAMP	Inventory Management	Air Force

Note: See footnotes at the end of the appendix.

System Name	System Acronym	System Function	Owner
Support Equipment Resources Management Information System[3]	SERMIS	Property Management	Navy
Uniform Automated Data Processing System-Inventory Control Point[3]	UADPS-ICP	Inventory Management	Navy
Uniform Automated Data Processing-System Stock Point[3]	UADPS-SP	Inventory Management	Navy

[1]This system is a critical finance system.
[2]This system is a critical accounting system.
[3]This system is a critical feeder system.

Appendix E. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

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 Organizations

Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency

Non-Defense Federal Organizations

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

Under Secretary of Defense (Comptroller) Comments

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

COMPTROLLER

FEB 26 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Draft of a Proposed Audit Report, Internal Controls and Compliance With Laws and Regulations for the Department of Defense Agency-wide Financial Statements for Fiscal Year (FY) 2000, Project No. D2001FI-0018.002 (dated February 23, 2001)

This is a combined Office of the Secretary of Defense (Comptroller) and Defense Finance and Accounting Service response to the subject draft report. As the Department was afforded only one business day to comment on the audit report, the Department did not have sufficient time to review and provide detailed comments on the report. Nor did the Department have sufficient opportunity to determine the validity of the assertions in the draft report. Most of the underlining detailed audit reports on the Department's FY 2000 financial statements have not yet been provided to this office by the audit community as of the date of this reply. Additionally, the auditors have not yet provided a listing of the accounting entries/journal vouchers that they consider unsupported, or the specific reason for their determinations. Further, the report did not advise, but should have advised, readers that accounting entries highlighted in the report are made primarily for the purpose of preparing year-end audited financial statements, that such accounting entries are a normal part of government and commercial year-end accounting processes, and that many such entries are not required for and are not a normal part of the Department's day-to-day accounting processes.

The Department continues to make significant progress improving its financial management operations. Entities such as the Defense Finance and Accounting Service and the Military Retirement Fund received unqualified audit opinions on their FY 2000 financial statements. Furthermore, the Department reduced departmental accounting entries by over 40 percent and reduced alleged unsupported adjustments by over 50 percent. The OIG, DoD report, however, does not offer an opinion on the overall direction, or rate, of financial management improvement being achieved by the Department. That the Department made notable financial management improvements in FY 2000 that should be recognized explicitly in the Executive Summary section.

My staff point of contact for this matter is Mr. Thomas Tresslar. He may be reached by e-mail: tresslat@osd.pentagon.mil or by telephone at (703) 693-6502.

Nelson Toye

Nelson Toye
Deputy Chief Financial Officer

Exhibit 1. Management Representation Letter

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

COMPTROLLER

FEB 15 2001

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: Management Assurance Concerning Fiscal Year (FY) 2000 Department of Defense Agency-wide Financial Statements

This is in regard to your audit of the FY 2000 Department of Defense (DoD) Agency-wide Financial Statements (Project No. D2001FI-0018.00). The financial statements include the Principal Statements (which are the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, the Statement of Custodial Activity, and the Notes to the Principal Statements) and the Required Supplementary Stewardship Information, as of September 30, 2000. This memorandum provides assertions central to your determination of: (1) an opinion as to whether the financial statements and required supplementary stewardship information are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP); and (2) whether the agency's financial management systems substantially comply with federal financial management systems requirements, applicable GAAP and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2000.

I confirm, to the best of my knowledge and belief, that the following representations are accurate as of the date of this letter, and pertain to the period covered by the Principal Statements.

1) I am responsible for the fair presentation of the FY 2000 DoD Agency-wide Financial Statements in conformity with GAAP.

2) The FY 2000 DoD Agency-wide Financial Statements may not be presented in full conformity with GAAP.

3) To the best of my knowledge, the Department has made available to you all financial records and related data, and communications from the Office of Management and Budget (OMB) concerning noncompliance with or deficiencies in financial reporting practices.

4) I have no knowledge of material transactions that have not been properly recorded in the accounting records underlying the financial statements or disclosed in the notes to the financial statements that are not a matter of public record.

5) To the best of my knowledge, the DoD has satisfactory title to all owned assets, including stewardship property, plant, and equipment; such assets have no liens or encumbrances, nor have any assets been pledged, that are not a matter of public record.

6) I have no plans or intentions, other than those previously disclosed, that may materially affect the carrying value or classification of assets and liabilities.

7) To the best of my knowledge, guarantees under which the DoD is contingently liable have been properly reported or disclosed.

8) Transactions for related parties (entities in which the Department has an ownership interest or significant management control) and related accounts receivable or payable, including assessments, loans, and guarantees may not all have been properly recorded and disclosed.

9) Intragovernmental transactions may not all have been explicitly disclosed or eliminated.

10) To the best of my knowledge, there are no:

a. Possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, that are not a matter of public record;

b. Material liability or gain or loss contingencies that are required to be accrued or disclosed, that have not been accrued or disclosed, that are not a matter of public record; or

c. Unasserted claims or assessments that are probable of assertion and that must be disclosed, that have not been disclosed.

11) To the best of my knowledge, the Department has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

12) I have no knowledge of material events or transactions that occurred subsequent to September 30, 2000, that have not been properly recorded in the Principal Statements, properly recorded in the Required Supplementary Stewardship Information, or disclosed in the notes thereto.

13) To the best of my knowledge, there has been no material fraud (intentional misstatements or omissions of amounts or disclosures in financial statements and misappropriation of assets that could have a material affect on the Principal

Statements or the Required Supplementary Stewardship Information) nor any fraud involving management or employees who have significant roles in internal control, that is not a matter of public record.

14) I am responsible for ensuring the establishment and overseeing the maintenance of internal controls for financial management.

15) Pursuant to the Federal Managers Financial Integrity Act, I have assessed the effectiveness of the DoD's internal controls in achieving the following objectives:

a. Reliability of financial reporting--properly recording, processing, and summarizing transactions to permit the preparation of the Principal Statements and Required Supplementary Stewardship Information in accordance with GAAP, and the safeguarding of assets against loss from unauthorized acquisition, use or disposition.

b. Compliance with applicable laws and regulations--executing transactions in accordance with (i) laws governing the use of budgetary authority and other laws and regulations that could have a direct and material effect on the financial statements, and (ii) any other laws, regulations, and government-wide policies identified by the OMB in Appendix E of OMB Bulletin 01-02; and

c. Reliability of performance reporting--properly recording, processing, and summarizing transactions and other data that support reported performance measures to permit the preparation of performance information in accordance with criteria stated by management.

16) To the best of my knowledge, the controls in place on September 30, 2000, provided reasonable assurance that the foregoing objectives were met except for the material weaknesses discussed in the Department's FY 2000 Statement of Assurance.

17) I am responsible for implementing and maintaining financial management systems that comply substantially with federal financial management systems requirements established by the OMB, applicable GAAP, and the U.S. Government Standard General Ledger at the transaction level.

18) I have assessed the financial management systems to determine whether they comply substantially with these federal financial management systems requirements. These assessments were based on criteria established by the OMB.

19) As of the date of this letter, a number of the entity's financial management systems do not comply substantially with federal financial management systems requirements, applicable GAAP, and the U.S. Government Standard General Ledger at the transaction level, and did not do so as of September 30, 2000. The

Department's FY 2000 Statement of Assurance provides information on the nature and extent of the noncompliance.

20) I am responsible for overseeing the DoD's compliance with laws and regulations applicable to the Department's financial statements.

21) I am not aware of any laws and regulations that have a direct and material effect on the determination of financial statement amounts that have not been disclosed.

22) To the best of my knowledge, I have disclosed all known instances of noncompliance with laws and regulations applicable to the Department's financial statements.

The point of contact for this matter is Mr. William J. deBardelaben. He may be reached by e-mail: debardew@osd.pentagon.mil or by telephone at (703) 697-0585.

Nelson Toye

Nelson Toye
Deputy Chief Financial Officer

Exhibit 2. Legal Representation Letter

GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
1600 DEFENSE PENTAGON
WASHINGTON, D. C. 20301-1600

GENERAL COUNSEL

FEB 0 6 2001

MEMORANDUM FOR THE ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: LEGAL REPRESENTATION LETTER FOR AUDITORS CONCERNING THE DEPARTMENT OF DEFENSE FISCAL YEAR 2000 DEFENSE-WIDE CONSOLIDATED FINANCIAL STATEMENTS

* REFERENCES:

(a) USD(C) Memorandum dated December 6, 2000, Subject: Office of Inspector General's Audit of the Fiscal Year 2000 Consolidated Department of Defense Financial Statements

(b) DoD Directive 5145.1, dated December 15, 1989, "General Counsel, Department of Defense"

(c) DoD Directive 5145.4, dated December 15, 1989, "Defense Legal Services Agency"

(d) Statement of Federal Financial Accounting Standard (SFFAS) No. 5, "Accounting for Contingencies," December 1995, as amended by SFFAS Number 12, and Interpretation Number 2 of SFFAS Numbers 4 and 5

(e) Department of the Army General Counsel Memorandum to the Auditor General, Department of the Army, dated December 15, 2000, Subject: Legal Representation Letter, Fiscal Year 2000, Army Litigation and Contingencies (Tab 1)

(f) Department of the Navy General Counsel Memorandum to the Auditor General, Department of the Navy, dated December 12, 2000, Subject: Legal Representation Letter for the Fiscal Year 2000 Year-End Department of the Navy General Fund Financial Audit (Tab 2)

(g) Department of the Navy General Counsel Memorandum to the Auditor General, Department of the Navy, dated December 12, 2000, Subject: Legal Representation Letter for the Fiscal Year 2000 Year-End Department of the Navy Working Capital Fund Financial Audit (Tab 3)

* We removed all references in this letter from our audit report on "Internal Controls and Compliance with Laws and Regulations for the DoD Agency wide Financial statements for FY 2000."

(h) Department of the Air Force General Counsel Memorandum to the Auditor General, Department of the Air Force, dated December 15, 2000, Subject: Air Force Audit Agency Audit of the Air Force Fiscal Year (FY) 2000 Financial Statement–Interim Report (Tab 4)

(i) Defense Logistics Agency General Counsel Memorandum to the Assistant Inspector General for Auditing, Office of the Inspector General, Department of Defense, dated December 22, 2000, Subject: Defense Logistics Agency Working Capital Fund for FY 2000 (Tab 5)

(j) Department of Defense Acting General Counsel Memorandum to the Deloitte and Touche, LLP, through the Deputy Assistant Inspector General for Auditing, Department of Defense, Subject: Legal Representation Letter for Auditors Concerning the Department of Defense Fiscal Year 2000 Military Retirement Fund Financial Statements (Tab 6)

(k) American Bar Association Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975)

This memorandum responds to reference (a) which requests that my office provide information concerning "pending or threatened litigation where the amount of potential loss *exceeds $100 million*" with respect to the DoD-Wide Consolidated Financial Statements. Reference (a) requests that an interim response be provided including matters that existed as of September 30, 2000 and from the period September 30, 2000 through at least December 1, 2000. In addition, reference (a) requests that an updated response be provided including matters that existed as of September 30, 2000 through no earlier than February 1, 2001. Reference (a) further requests information concerning unasserted claims and assessments and requests confirmation that legal counsel are disclosing material loss contingencies as defined in reference (d).

Known Litigation, Claims and Assessments

As you are aware, the Fiscal Year 2000 Defense-Wide Consolidated Financial Statements covers those items which are the subject of the legal representation memoranda covered by references (e) through (j). References (e) through (i) have been submitted previously by the Military Departments and the Defense Logistics Agency and should form the basis for the required representations and evaluations for the matters covered by those memoranda. Reference (j) should form the basis for the required representations and evaluations for the matters covered by that memorandum. Collectively, references (e) through (j) should form the basis for the required representations and evaluations covered by all of the memoranda.

As Acting General Counsel of the Department of Defense, I have supervisory authority only with respect to claims and litigation made against the Department of Defense and its Agencies and Field Activities (References (b) and (c)). I have obtained copies of each of the legal representation memoranda identified in references (e) through (i) and have signed the legal representation memorandum identified in reference (j) in response to a separate request for the financial statement addressed in that reference. Collectively, and subject to the time periods and other qualifications addressed in each of the legal representation memoranda, they constitute the legal representation memoranda for the Fiscal Year 2000 Defense-Wide Consolidated Financial Statements.

Subject to the foregoing, and to the last paragraph of this memorandum, I advise you that, as of September 30, 2000 and from the period September 30, 2000 through February 1, 2001, neither I nor any of the lawyers over whom I exercise general supervision have given substantive attention to, or represented the Department of Defense, in connection with any known litigation, claim, or assessment of $100 million or more, except as indicated in the attachments to this memorandum.

With respect to those elements of the Fiscal Year 2000 Defense-Wide Consolidated Financial Statements pertaining to matters which are administered by the Military Departments, over whose legal staffs I exercise no supervisory responsibility with respect to the subject matter of reference (a), I expressly disclaim any responsibility for the accuracy or completeness of any information reported by the legal advisors to the Military Departments.

Copies of each of the foregoing references are attached and, together with the attachments to this memorandum, are considered to constitute the totality of legal representation matters pertaining to the subject matter covered by the Fiscal Year 2000 Defense-Wide Consolidated Financial Statements of the Fiscal Year 2000 Defense-Wide Consolidated Financial Statements.

Unasserted Claims and Assessments

Reference (a) requests information concerning unasserted claims and assessments which this office considers probable of assertion and, if asserted, would have a reasonable possibility of an unfavorable outcome. I have interpreted this request to refer to unasserted claims and assessments which, if asserted, have a reasonable possibility of resulting in a material unfavorable outcome where materiality is defined as $100 million or more.

Subject to the limitations on my authority stated in references (b) and (c), to Paragraph 5, clause (a) of reference (k), and to the last paragraph of this memorandum, and the information contained in references (e) through (j), I advise you that neither I nor any of the lawyers over whom I exercise general supervision have given substantive attention to, or provided representation in any matter covered by the Fiscal Year 2000 Defense-Wide Consolidated Financial Statements in connection with any unasserted claims or assessments which, if asserted, would constitute a material loss contingency within the scope of clause (a) of Paragraph 5 of reference (k).

Representation Concerning Disclosure

Subject to the limitations on my authority in references (b) and (c) and to the last paragraph of this memorandum, and consistent with the last sentence of Paragraph 6 of reference (k), this will confirm that whenever, in the course of performing legal services for the Department of Defense, its Agencies or Field Activities with respect to a matter recognized to involve an unasserted possible material claim or assessment in any matter covered by the Fiscal Year 2000 Defense-Wide Consolidated Financial Statements that may call for financial statement disclosure, I or one of the lawyers over whom I exercise general supervision have formed a professional conclusion that the Department must disclose, or consider disclosure, concerning such possible claim or assessment, the lawyer forming such professional conclusion will so advise the Department and will consult with the Department's financial managers concerning the question of such disclosure and the applicable requirements of reference (d).

Limitation on This Response

This response is limited by, and made in accordance with, the ABA Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975) (reference (k). Without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of reference (k) and the accompanying Commentary (which is an integral part of this Statement). In addition, we do not interpret reference (a) to require or authorize the release of information subject to the attorney-client privilege or the work product doctrine, and in responding to reference (a) we have provided no information subject to that privilege or doctrine. Moreover, except as otherwise indicated in references (e) through (j), the information set forth herein is as of February 1, 2001, and covers matters that existed as of September 30, 2000 and for the period September 30, 2000 to February 1, 2001, and I expressly disclaim any undertaking to advise you of changes which may be brought to my attention or to the attention of the lawyers over whom I exercise general supervision after the date of this memorandum. Finally, information reported herein relating to the Military Departments is reported as a courtesy and I hereby disclaim any responsibility for the accuracy or completeness of any information reported by the legal advisers of the Military Departments.

Daniel J. Dell'Orto
Acting General Counsel

Exhibit 3. Auditor Opinion

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

February 15, 2001

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

SUBJECT: Independent Auditor's Report on the Department of Defense Agency-wide Financial Statements for FY 2000 (Project No. D2001FI-0018.001)

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 and prescribes the responsibilities of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations. We attempted to audit the FY 2000 DoD Agency-wide Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Financing, Statement of Budgetary Resources, and Statement of Custodial Activity. As the Chief Financial Officer of DoD, the Under Secretary of Defense (Comptroller) is responsible for these financial statements, for establishing and maintaining internal controls, and for complying with laws and regulations applicable to DoD financial accounting and reporting. We did not audit the Army, Navy, and Air Force financial statements for FY 2000. The Military Department audit agencies attempted to audit those financial statements and issued disclaimers of opinion.

Disclaimer of Opinion. DoD could not provide sufficient or reliable information for us to evaluate management's assertions or verify amounts on the FY 2000 DoD Agency-wide Financial Statements. We identified deficiencies in internal controls and accounting systems related to General Property, Plant, and Equipment; Inventory; Environmental Liabilities; Military Retirement Health Benefits Liability; and material lines within the Statement of Budgetary Resources. We identified $1.1 trillion in department-level accounting entries to financial data used to prepare DoD component financial statements that were not supported by adequate audit trails or by sufficient evidence to determine their validity. In addition, we also identified $107 billion in department-level accounting entries to financial data used to prepare DoD component financial statements that were improper because the entries were illogical or did not follow accounting principles.

The financial data reported on the FY 2000 financial statements for Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; and the U.S. Army Corps of Engineers, Civil Works Program, were unauditable and comprise a significant portion of the financial data reported on the DoD Agency-wide Financial Statements for FY 2000.

Because internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist, we were not able to verify amounts reported for material line items on the financial statements. As a result, we do not express an opinion on these financial statements.

Required Supplementary Stewardship Information. The Stewardship Statement includes national defense property, plant, and equipment; heritage assets; and stewardship land. This information is not required to be audited. However, we applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with Federal accounting standards.

Required Supplementary Information for Deferred Maintenance. 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 such information. We did not apply certain 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.

Internal Controls. The internal controls consist of the following components: control environment, risk assessment, control activities, information and communication, and monitoring. Effective implementation of these controls provides reasonable assurance that accounting data are accumulated, recorded, and reported properly by management and that assets are safeguarded. Management is responsible for internal controls. We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. However, these tests did not provide sufficient evidence to support an opinion on internal controls; therefore, we do not express an opinion on the DoD internal controls.

The DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that adjustments to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-wide Financial Statements for FY 2000, the DoD Components Annual Statements of Assurance for FY 2000, and the DoD Financial Management Improvement Plan. A separate report discusses internal control weaknesses in further detail.

Compliance With Laws and Regulations. Our objective was to assess compliance with laws and regulations related to the DoD Agency-wide Financial Statements for FY 2000 and not to express an opinion. Therefore, we do not express an opinion on compliance with laws and regulations.

DoD did not fully comply with the laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. DoD financial management systems were not in substantial compliance with Federal financial management system requirements; applicable Federal accounting standards; and the U.S. Government Standard General Ledger at the transaction level, as required by the Federal Financial Management Improvement Act of 1996. For example, DoD financial management systems were not integrated; did not maintain adequate audit trails; did not value and depreciate property, plant, and equipment in accordance with Statement of Federal Financial Accounting Standards No. 6; and did not incorporate the U.S. Government Standard General Ledger at the transaction level. In addition, DoD did not fully comply with the Chief Financial Officers Act of 1990, the Government Performance and Results Act of 1993, the Federal Managers' Financial Integrity Act of 1982, as codified in Section 3512, Title 31, United States Code, and Office of Management and Budget Bulletin 97-01. Our work would not necessarily disclose all material weaknesses. A separate report discusses compliance issues in further detail.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

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