

July 9, 2002



Financial Management

Department of Defense's
Compliance with Internal Use
Software Accounting Standards
(D-2002-127)

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

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Acronyms

| | |
|------------|--|
| COTS | Commercial Off-the-Shelf |
| DFAS | Defense Finance and Accounting Service |
| DoDEA | Department of Defense Education Activity |
| FMR | Financial Management Regulation |
| PP&E | Property, Plant, and Equipment |
| SFFAS | Statement of Federal Financial Accounting Standards |
| USD(C/CFO) | Under Secretary of Defense (Comptroller)/Chief Financial Officer |
| WAAS | Washington Headquarters Services Allotment Accounting System |
| WHS | Washington Headquarters Services |



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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July 9, 2002

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER
ASSISTANT SECRETARY OF DEFENSE (COMMAND,
CONTROL, COMMUNICATIONS, AND
INTELLIGENCE)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on Department of Defense's Compliance With Internal Use
Software Accounting Standards (Report No. D-2002-127)

We are providing this report for your information and use. We performed the audit to support the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We considered management comments on the draft of this report when preparing the final report.

Comments conformed to the requirements of DoD Directive 7650.3. Therefore, no additional comments are required.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. David F. Vincent at (703) 604-9109 (DSN 664-9109) (dvincent@dodig.osd.mil) or Ms. Barbara A. Sauls at (703) 604-9129 (DSN 664-9129) (bsauls@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Acting Assistant Inspector General
for Auditing

Office of the Inspector General of the Department of Defense

Report No. D-2002-127

July 9, 2002

(Project No. D2001FH-0079)

Department of Defense's Compliance With Internal Use Software Accounting Standards

Executive Summary

Who Should Read This Report and Why? Financial managers, budget analysts, and managers responsible for property accountability should read this report. This report provides insight in implementing new or changing guidance from the Financial Accounting Standards Board.

Background. This audit was performed to support the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. The accuracy of the \$113.8 billion of property, plant, and equipment reported on the FY 2001 DoD Agency-Wide Financial Statements is essential to DoD receiving favorable audit opinions on its financial statements. From FY 1999 to FY 2002, DoD budgeted more than \$19 billion annually for information technology and national security systems. However, on the FY 2001 DoD Agency-Wide Financial Statements, DoD reported less than \$1.4 billion for software for the entire Department. More than \$874 million of this amount was from two organizations, the U.S. Transportation Command and the Defense Finance and Accounting Service. On the FY 2001 DoD Agency-Wide Financial Statements, the Defense Finance and Accounting Service reported \$1 billion in software costs for the Other Defense Organizations. Within the Other Defense Organizations are the Defense agencies, the Office of the Secretary of Defense, the Joint Staff, and the DoD Field Activities. Our audit involved the Office of the Secretary of Defense, the Joint Staff, and the DoD Field Activities, referred to collectively as DoD Components.

Results. The DoD Components were expensing instead of capitalizing software on the financial statements. The DoD Components did not comply with the reporting requirements of the Statement of Federal Financial Accounting Standard No. 6, "Accounting for Property, Plant, and Equipment," and the Statement of Federal Financial Accounting Standard No. 10, "Accounting for Internal Use Software." Only two of the six DoD Components visited reported capitalized software on the DoD FY 2000 and FY 2001 DoD Agency-Wide Financial Statements. As a result, the DoD Components understated the software asset account (1830) by at least \$44.6 million in FY 2000 and at least an additional \$10.3 million in FY 2001. In addition, DoD Components erroneously expensed at least \$188.7 million in FY 2000 and at least an additional \$102.8 million in FY 2001. More specific guidance from the Under Secretary of Defense (Comptroller)/Chief Financial Officer on accounting for internal use software and a system to capture the costs would improve the accuracy of the reported amounts on the financial statements. (See finding A for the detailed recommendations.)

The DoD Components did not have subsidiary ledgers to support the amounts reported in the general ledger. As a result, they did not have the necessary information to calculate software depreciation and to support the reported values for internal use

software. Complying with DoD regulations for property accountability should provide the information needed to calculate and support reported values for software depreciation and internal use software. (See finding B for the detailed recommendations.)

Management Comments. The Under Secretary of Defense (Comptroller)/Chief Financial Officer and the Director, Defense Finance and Accounting Service concurred with the recommendations. The Directors of the Defense Human Resources Activity, the Department of Defense Education Activity, and TRICARE Management Activity also concurred with the recommendations and agreed that additional guidance was needed to properly implement the requirements of the Statement of Federal Financial Accounting Standard No. 10. We made minor revisions to the report based on comments from the TRICARE Management Activity. We also worked closely with the “Internal Use Software” working group composed of the Property, Plant, and Equipment Program Management Office and individuals from the financial management and information technology communities. We commend the staff on their aggressive approach to implementing corrective actions. See the Finding section of the report for a discussion of the management comments and to the Management Comments section of the report for the complete text of the comments.

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Background

Other Defense Organizations. This audit was performed to support the requirements of 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, which requires DoD to prepare annual audited financial statements. The DoD Agency-Wide financial statements include a reporting entity entitled “Other Defense Organizations-General Fund.” Within this entity is the Office of the Secretary of Defense, the Joint Staff, and smaller field activities that individually represent DoD programs. We judgmentally selected the Office of the Secretary of Defense, the Joint Staff, TRICARE Management Activity, Defense Human Resources Activity, Department of Defense Education Activity (DoDEA), and the Washington Headquarters Services (WHS) for our review. We also sent survey questionnaires to various Defense agencies to obtain general information on what the agencies were doing to comply with the Statement of Federal Financial Accounting Standard (SFFAS) No. 10.

Statement of Federal Financial Accounting Standards. Our audit focused on compliance with two Statements of Federal Financial Accounting Standards. SFFAS No. 6, “Accounting for Property, Plant, and Equipment,” (SFFAS No. 6) was issued with an effective implementation date of October 1, 1997. SFFAS No. 6 requires all Federal agencies to capture and report contractor-developed software and commercial off-the-shelf (COTS) software costs as property, plant, and equipment (PP&E) costs. SFFAS No. 6 did not permit the capitalization of internally developed software except in those instances when management intended to recover the cost through user charges. SFFAS No. 10, “Accounting for Internal Use Software,” effective October 1, 2000 (SFFAS No. 10) amended SFFAS No. 6 and requires the capitalization of internal use software whether it is COTS, contractor-developed, or internally developed software. The capitalization of internally developed software was no longer restricted to those instances where development costs were recouped through user charges.

Information Technology Resources. Agencies are required to report software that meets the DoD capitalization threshold. Software has its own general ledger account codes. The “Construction-in-Progress” account 1720 is the account used to accumulate all software costs. The 1830 account, “Information Technology Software,” is the account to be used to record software as an asset if all accumulated costs exceed the capitalization threshold. Beginning in FY 2002, the “Internal-Use Software In Development” account 1832 will be used instead of 1720. Table 1 presents the amounts included in the President’s budget for FY 2001 for information technology to include software and hardware costs for all of DoD.

**Table 1. FY 2001 Information Technology Resources by Component
(millions)**

| Component | FY 1999 | FY 2000 | FY 2001 |
|----------------------|--------------------|--------------------|--------------------|
| TRICARE | \$ 807.9 | \$ 789.0 | \$ 811.5 |
| OSD | 365.9 | 343.4 | 277.8 |
| DHRA | 86.7 | 114.9 | 110.1 |
| WHS | 111.1 | 128.8 | 141.0 |
| Joint Staff | 74.9 | 71.3 | 90.3 |
| DoDEA | 69.4 | 48.2 | 63.1 |
| Other DoD Components | 18,182.8 | 18,499.3 | 18,419.9 |
| Total | \$ 19,698.7 | \$ 19,994.9 | \$ 19,913.7 |

DHRA - Defense Human Resources Activity
DoDEA - DoD Education Activity
OSD - Office of the Secretary of Defense
TRICARE - TRICARE Management Activity
WHS - Washington Headquarters Services

Objectives

Our overall audit objective was to determine whether DoD is in compliance with SFFAS No. 10. This standard requires all Federal agencies to report internal use software in a specified and consistent manner. To achieve this objective, we also reviewed the procedures for collecting and reporting internal use software on the financial statements and the management control program as it related to the overall objective. See Appendix A for a discussion of the audit scope, methodology, and review of the management control program.

A. Compliance With Internal Use Software Accounting Standards

The DoD Components did not comply with the reporting requirements of SFFAS No. 6, “Accounting for Property, Plant, and Equipment” and SFFAS No. 10, “Accounting for Internal Use Software.” The noncompliance occurred because DoD policies and procedures were either not in place or not followed to ensure that internal use software was reported in a specified and consistent manner. Specifically,

- the Under Secretary of Defense (Comptroller)/Chief Financial Officer (USD[C/CFO]) did not update and distribute guidance on the new requirements of SFFAS No. 10 in a timely manner;
- the DoD Components and the Defense Finance and Accounting Service (DFAS) did not have standard accounting codes that clearly defined whether software costs should be capitalized, expensed, or placed in a software in development account. In addition, DoD guidance was unclear on the use of the construction-in-progress account (1720);
- the DoD Components did not have a cost accounting process to capture material internal costs related to COTS, contractor-developed, and internally developed software. As a result, the software asset account (1830) was understated by at least \$44.6 million in FY 2000 and at least an additional \$10.3 million in FY 2001. In addition, the construction-in-progress account (1720) was understated by at least \$188.7 million in FY 2000 and at least an additional \$102.8 million in FY 2001. These errors also overstated expenses for FYs 2000 and 2001.

Survey Questionnaire

In order to satisfy the requirements of the internal use software accounting standards, a significant amount of work is required by DoD. In May 2001, we prepared and distributed a questionnaire on accounting for internal use software to selected DoD Components within the National Capital Region. The purpose of the survey was to gather information about the Department’s internal use software reporting. Eleven organizations responded to the survey. The organizations responding affirmatively to a survey question are identified in Table 2.

| Table 2. Survey Results | |
|---|--|
| Survey Question | Components Indicating an Affirmative Response |
| Had established an inventory record of software. | DTRA, DeCA, DCAA, NIMA |
| Issued implementing guidance on internal use software. | DeCA, DFAS |
| Charged the 1830 Information Technology Software account for software costs. | Although no component responded affirmatively in the survey, the data indicate that DFAS did charge the 1830 account for software costs. |
| Charged an account other than 1720 for construction-in-progress | DeCA, DISA, DFAS, DTRA, DHRA, NIMA |
| Had infrastructure in place to capture software costs. | DeCA, DCAA, DISA, DTRA |
| Reported internal use software in financial systems, including FY 2000 year-end balances. | DTRA, DeCA, DCAA |
| Made material enhancements/upgrades to software. | NIMA, DTRA, Joint Staff- (J7) |
| Compared budgeted costs for software to actual disbursements for software. | DHRA, NIMA, TRICARE |
| List of Eleven Survey Respondents | |
| DARPA-Defense Advanced Research Projects Agency DoDEA-DoD Education Activity DCAA-Defense Contract Audit Agency DTRA-Defense Threat Reduction Agency DeCA-Defense Commissary Agency Joint Staff-J3, J4, and J7 DFAS-Defense Finance and Accounting Service NIMA-National Imagery and Mapping Agency DHRA-Defense Human Resources Activity TRICARE-TRICARE Management Activity DISA-Defense Information Systems Agency | |

DFAS and WHS had prior knowledge of SFFAS No. 10. The Defense Commissary Agency response to the survey implied that they also had prior knowledge of SFFAS No. 10. Because of their knowledge, the Defense Commissary Agency and DFAS had issued internal guidance on accounting for internal use software. The survey showed that seven Components did not maintain inventory records. Seven Components also noted that they did not have an infrastructure or cost accounting process to capture the costs of developing internal use software. Few charges had been made to the general ledger account code 1830 even though the DoD Components budgeted millions of dollars for information technology and the use of the 1830 account was applicable in FY 2000.

Updating and Disseminating Guidance

SFFAS No. 10 Guidance. SFFAS No. 10, “Accounting for Internal Use Software,” was published on October 9, 1998, with an effective date of FY 2001. SFFAS No. 10 further clarified and defined the term “internal use software,” incorporating the reporting of all three types of software regardless of whether an organization was a working capital or general fund activity. SFFAS No. 10 also included specific rules for recognition, measurement, and disclosure. However, DoD guidance was not promptly updated to incorporate these new software-reporting requirements. In addition, DoD did not adequately disseminate the guidance to all DoD Components. Although Federal entities were allowed to continue their current accounting practices for internal use software for accounting periods prior to and including September 30, 2000, the Financial Accounting Standards Advisory Board encouraged early implementation of SFFAS No. 10.

DoD Guidance. The DoD software reporting policies are contained in the DoD Financial Management Regulation (FMR), Volume 4, chapters 6 and 7. The August 2000 chapter 6 revisions for software essentially incorporated the key provisions of SFFAS No. 10. Chapter 6 defines the three types of software and uses similar language as the standard to describe what COTS and contractor-developed software costs to capitalize. For internally developed software, it adds details about which costs to capitalize. Chapter 6 states that data conversion costs are not capitalized, and capitalization for developed software should not begin until after final acceptance testing. DoD Components must capitalize enhancements when the cost of the enhancement exceeds the capitalization threshold and the enhancement adds significant additional capability. Finally, chapter 6 includes guidance on how, when, and what costs to write off when software is impaired along with criteria for determining impairment.

The September 1999 revision to chapter 7 includes a change from the January 1995 version that stated costs for in-house developed software be transferred from an Inventory-Work in Process-In-House account. The September 1999 revision referenced the construction-in-progress account for software in development and explained what costs should be capitalized for the three categories of software presented in SFFAS No. 10. It requires capitalization of software that has an expected life of 2 or more years. Finally, it extends the requirement for depreciating software to all software, not just software used by components that recover costs through the sale of goods and services.

On December 21, 2000, the USD(C/CFO) issued a memorandum entitled “New Standard for Internal Use Software” nearly 2 months past the effective date for implementation. In the memorandum, the USD(C/CFO) stated that because of the amount of software within DoD, “... all DoD communities should be made aware of the new mandatory requirements. Therefore, the information in the attachment should be disseminated in a manner that will achieve the widest possible distribution.” We agree with this concern and believe that in addition to the regular distribution channels, electronic versions of changes to major

guidance should be sent to decisionmakers in the DoD functional communities. This process would serve to provide greater awareness throughout DoD of major policy changes.

DFAS Guidance. The Department of Defense Financial Management Improvement Plan, Volume I of II, January 2001, states that DFAS has a responsibility to produce procedural guidance to supplement USD(C/CFO) policy guidance. Specifically, DFAS is expected to provide consistent policies and procedures for financial transactions throughout DoD, ensure compliance with financial policies, and review safeguards for verifying the existence of assets. For software reporting, the Department of the Treasury established the 1830 account for capitalized software costs and the 1720 account for PP&E, which includes software in development. Subsequently, DoD incorporated both accounts in the FMR. Once DoD updates the FMR, DFAS is responsible for incorporating the new accounts in its financial reports and for providing procedural guidance to Components on what software costs should be reported to DFAS. This may require a new conversion system from the DoD Components' budget data to the general ledger accounts. DFAS did not provide this guidance to the DoD Components. As a result, software costs that should have been capitalized were expensed, and software in development costs were erroneously posted to other accounts such as "Equipment" and "Equipment Not In Use."

Accounting for Software Costs

The DoD Components did not have adequate procedures or processes in place for recording software transactions. The lack of adequate procedures occurred because DFAS and the DoD Components did not have standard accounting codes that identified whether the cost of a software item should be recorded as an asset (capitalized), an expense (expensed), or placed in a construction-in-progress account for software in development. In addition, DoD guidance was unclear on the use of the construction-in-progress account (1720). As a result, with minor exceptions, DoD Components expensed nearly all items rather than capitalizing the items when the costs met or exceeded the DoD capitalization threshold, currently at \$100,000.

To correctly record a transaction, the accounting entity must know whether the transaction is for hardware, software, or services. The entity must know whether the transaction amounts are for continuing operations or modernization. In addition, to further decide the appropriate way to account for costs, the DoD Component identifies the source of the software, that is, COTS, contractor-developed, or internally developed. For COTS software, the DoD Component must determine whether the cost is under or over the DoD capitalization threshold. If under the threshold, the DoD Component must record the transaction to an expense account; if over the threshold, to a capital account. When software is contractor-developed, the DoD Component must first identify whether the total cost of the project (contract) is under or over the DoD capitalization threshold. If the contract is over the threshold, the DoD Component must determine whether the contract includes costs that it should capitalize and costs it should expense. For example, the DoD Component must expense the cost of data conversion when purchasing new software. Until the

software in development is completed, the DoD Components must record the costs to be capitalized in a construction-in-progress account. When completed, the project costs are transferred to an asset account (capitalized) and the in-process account is reduced by the same amount.

Washington Headquarters Services Allotment Accounting System. The Washington Headquarters Services Allotment Accounting System (WAAS) is the accounting system used by all the DoD Components reviewed, except for the Defense Human Resources Activity. Budget personnel from the Joint Staff, TRICARE Management Activity and DoDEA reported cost data via a transfer file to WAAS. The costs were classified, not by general ledger codes, but by four-digit object class codes used by the DoD Components. For example, the WAAS would capitalize or expense an asset based on the appropriation used. If the software was purchased with an investment appropriation such as procurement, or research and development, had an object class code 31, and cost more than \$100,000, WHS would capitalize it. The WAAS then downloaded the data into its system. If the software was procured with an investment appropriation, cost more than \$100,000 but was not coded with object class 31, the transaction would have been expensed. The inconsistent use of object class codes resulted in inconsistencies in how costs were defined and reported.

Capitalized Versus Expensed Codes. The Office of Management and Budget developed object classes or accounting codes that identify the transactions of the Federal Government by the nature of the items or services it purchases. Every obligation recorded by the Government must be coded with an object class. Organizations generally add additional digits to the basic object class code to give further classification breakdown to transactions. As a result, the DoD Components did not have uniform codes to distinguish among recording transactions to a software capital asset account, to an expense account, or a construction-in-process account. Each activity had its own set of object classes. For Chief Financial Officer reporting, the object classes are mapped to standard general ledger account codes, which are the codes used to classify transactions in the general ledger. However, the lack of uniformity hindered the consistent mapping of these object classes to general ledger accounts.

The DoD FMR also establishes broad classes of object class codes in Volume 1, Appendix A, "Object Classification," May 1993. Approved object classes for recording software transactions are either in the 25 series, "Other Services," 26 series, "Supplies and Materials," or 31 series, "Equipment." The explanation accompanying object class 25 states that it is to be used for custom software, which is defined as "Obligations for contracts covering development of software of \$25,000 or less." The 26 series states that the object class is for recording transactions for off-the-shelf software purchases and licenses of \$25,000 or less. Object class 31 is to be used for off-the-shelf and custom software costing more than \$25,000. These explanations are not entirely consistent with other DoD FMR chapters and need to be revised for clarity. For example, the object classes should be revised to match volume 4, chapter 6, which establishes the three types or source of software, that is, COTS, contractor-developed, and internally developed. The 25 series should refer to contractor-developed, the 26 series should refer to COTS, and the 31 series should refer to all three types of software when the cost meets or exceeds the

capitalization threshold. An object class also needs to be added for internally developed software. Additionally, the \$25,000 amount was the capitalization threshold in effect when DoD published the Appendix, but the current threshold is \$100,000.

Although the DoD FMR establishes groups of object classes, the DoD Components either established specific object classes or else used the object class codes provided by their accounting entities. The Office of the Secretary of Defense and WHS used the same object classes for recording transactions. TRICARE Management Activity used the object classes provided by DFAS, and DoDEA used its own object classes. The Joint Staff used object class codes that were originally developed by DFAS, and had not been updated since October 1995.

Changes relating to object class codes need to be implemented. A new object class code should be established for internal use software to be reported consistently in the financial records. This means that the amount of internal use software costs having a cumulative value above the current financial threshold amount would have to be identified by a new object class code. The object class codes would identify capitalizable, expendable, and software in development. This would allow for consistent recording of software costs.

Cost Accumulation. SFFAS No. 6 was issued with an effective implementation date of October 1, 1997. SFFAS No. 6 requires all Federal agencies to capture and report contractor-developed software and COTS software costs as PP&E costs. On the FY 2000 and FY 2001 financial statements, version 2, TRICARE did not accurately report all applicable software costs as software capitalized assets. TRICARE had deployed at least \$44.6 million worth of software to the Services for their use in FY 2000 and \$10.3 million in FY 2001. These costs should have been reported in the TRICARE 1830 account.

Use of Appropriation Codes. As stated before, whether WAAS capitalizes costs depends upon the appropriation used and the object code. This will be shown in a trial balance by fiscal year and by appropriation. To know the total amount of PP&E or software reported, we must look at each trial balance by appropriation. Software may be reported using procurement or research and development appropriations. The totals for these appropriations are then rolled up into a figure on the consolidated trial balance. However, when reviewing the trial balances, both the DoD Components and DFAS had problems determining first, whether any amount was capitalized for software, and second, if so, how much.

When we asked both DFAS and the Office of the Secretary of Defense management about the \$569 million reported in the construction-in-progress account (1720) on the version 1 financial statements, we found that the costs were for base realignment projects, not software in development costs. Other DoD Components had funds shown in the construction-in-progress account, but the applicable appropriation was the military construction appropriation. For example, in FY 2001, the TRICARE Management Activity used the research and development appropriation to account for software costs. However, during our review of the year-end financial statements, the 1720 account had \$419 million that related to military construction, not research and development.

Use of the Construction-in-Progress Account. The DoD Components did not maintain a construction-in-progress account for accumulating the costs of software in development. The DoD Components did not maintain the account because DoD lacked clarity in its guidance on the construction-in-progress account. As a result, DoD Components were expensing most costs for software in development and were not accumulating expenditures for capitalization when projects were completed.

Although SFFAS No. 6 required reporting COTS and contractor-developed software beginning in FY 1998, it did not address recording costs for software in development. In addition, the DoD reporting guidance in effect at the time was inadequate. The FMR, chapter 7, January 1995, included an erroneous sample accounting entry for software showing that software in development was recorded to Inventory-Work in Process-In-House.

In September 1999, USD(C/CFO) reissued chapter 7, with significant additional policy guidance for reporting software amounts, including using the construction-in-progress account to record software in development. Internal use software was defined in terms of three categories. The policy guidance included an example of an accounting entry showing that the offset to the internal use software account was the construction-in-progress account. When completed, the agency must capitalize the software and reduce the construction-in-progress account by the same amount.

USD(C/CFO) reissued chapter 6 in August 2000. The change created uncertainty about use of the construction-in-progress account for software as called for by chapter 7 in September 1999. Specifically, when describing account 1720, "Construction-in-Progress," chapter 6 states that the construction-in-progress account should be used to accumulate the costs of real property construction projects. There was no mention that agencies should use the account to record the cost of software in development.

For FY 2002, the Department of the Treasury created a new general ledger account code for software in development. The code, 1832, is defined as "Internal-Use Software in Development." Incorporating this code in the DoD FMR and modifying the DoD FMR to eliminate discussion about using account 1720, Construction-in-Progress, for accumulating the costs of software in development, should clearly identify the requirement to report software development costs.

Because the DoD Components did not account for software in development, we used several means to arrive at the estimated minimum value of unreported software in development costs displayed in Table 3. We derived our estimate for the Joint Staff by adding together the value of the contracts it awarded for four major systems currently under development. The four systems included the Network Warfare Simulation, Joint Satellite Communication Architecture Planning and Evaluation, Joint Warfare System, and Joint Simulation System. The TRICARE Management Activity calculated the FY 2000 estimate shown in Table 3 from the software costs allocated for the Clinical Information Technology Program. The \$52.7 million shown as unreported in FY 2001 for TRICARE was obtained from the TRICARE Capital Asset Report. TRICARE sent this report to DFAS showing the amount of completed software as well as

the amount of software under development. DFAS did not post the costs to the FY 2001 year-end financial statements. Finally, we obtained the estimate for the Office of the Secretary of Defense High Performance Computer Program from the “DoD High Performance Computing Modernization Program-Modernization Plan 2000, June 2000.” Our estimates are not intended to be a substitute for agency work to establish the construction-in-progress amount for software currently under development. Rather, our intent is to establish an order of magnitude estimate about the value of the unreported software costs. The DoD Components and DFAS should know whether a specific number of projects with reported cost expenditures of a specific amount were reported in the financial statements in the 1720 account.

| Other Defense Organizations | FY 2000 Reported | FY 2000 Unreported | FY 2001 Reported | FY2001 Unreported |
|------------------------------------|------------------|--------------------|------------------|-------------------|
| Joint Staff | \$0.0 | \$78.1 | \$0.0 | \$27.8 |
| TRICARE | 0.0 | 23.4 | 0.0 | 52.7 |
| Office of the Secretary of Defense | 0.0 | 87.2 | 0.0 | 22.3 |
| Total | \$0.0 | \$188.7 | \$0.0 | \$102.8 |

As stated before, TRICARE sent a Capital Asset Report to DFAS in response to the year-end data call for general property, plant, and equipment information. We commend TRICARE for providing the requested information to DFAS. However, the Capital Asset Report does not provide enough information to accurately calculate the amount of amortization or depreciation associated with completed projects. Inspector General of the Department of Defense Report No. D-2000-128, “Defense Health Program Financial Reporting of General Property, Plant, and Equipment,” May 22, 2000, discusses the need for property records to accumulate software development costs and provide PP&E information for annual financial statements. The report recommended that the TRICARE Management Activity develop property records to accumulate and report software costs to DFAS. The property records would provide supporting documentation for the amount of software reported on the financial statements and financial reports. In addition, the information contained in the property records is needed as a basis for calculating accumulated amortization or depreciation. Without this information, there would be no support for the reported amounts. The property records would also serve as a subsidiary ledger to support the costs reported on the financial statements. The need for property records will be further discussed in finding B.

Cost Accounting Process

DoD Components have not established a cost accounting process to capture material internal costs related to software investment costs. A process is necessary in order to comply with SFFAS No. 10, which requires that all material costs related to the development of internal use software be reported. Since very few of the DoD Components develop their own software, the standard applies primarily to DoD Components that have material costs in implementing contractor-developed software. This classification would only apply to major programs exceeding the financial reporting threshold level for software, currently \$100,000.

SFFAS No. 10 requires that both direct and indirect costs be captured. Direct costs are primarily reflective of the time spent on a software project and the translation of the time through the payroll process to payroll costs. The system to capture these costs may be as simple as an existing project management system that records assigned time for each project and could be used to provide the basis for a payroll cost estimate. However, capturing indirect costs requires allocation and reclassification. Examples of indirect costs would include rent or utilities. In the case of rent, the organization would make an allocation assumption based on the square footage that personnel use to implement the software project. The portion of square footage used in the software project has to be translated into costs and ultimately charged to the internal use software in development account. In this case, the reclassification process is the accounting method used to transfer the costs from one account, the rent account, to another account, the internal use software in development account.

The methodology used to capture and report material direct and indirect costs for internal use software requires coordination between the Components and its accountant, DFAS. In addition, coordination is required within sectors of the Components itself. Information technology personnel, specifically the project manager or managers of major projects are the personnel with the most up-to-date operational knowledge of their projects. The project's phase and time allocations are factors that must be considered by resource management personnel in financial reporting.

Property, Plant, and Equipment Program Management Office

Although DoD did not follow early implementation of SFFAS No. 10, the PP&E Program Management Office did establish an "Internal Use Software" working group to assist in implementing this new accounting standard.

The group is composed of individuals from the financial management and information technology communities. The working group's stated objectives are the following.

- Review the requirements of SFFAS No. 10 and the DoD FMR to clarify and develop any such additional guidance as may be needed.

-
- Identify DoD internal use software meeting the reporting requirements.
 - Develop a methodology to capture internal use software expenditures through DoD accounting systems for capitalization or expense.
 - Draft reporting procedures to disclose, in DoD financial statements, the cost of internal use software.

The working group held its first meeting on July 31, 2001. The establishment of the working group and the formulation of its stated objectives are positive steps taken to address the relevant SFFAS No. 10 issues.

Summary

USD(C/CFO) and DFAS guidance was not adequate for timely, accurate, and consistent reporting of software costs. In addition, DoD did not provide adequate guidance to identify software as an asset or expense item and the need to record software in development in a construction-in-progress account. As a result, the DoD Components did not properly report the costs of COTS software and completed contractor-developed software on the FY 2000 and FY 2001 DoD Agency-Wide Financial Statements. In view of the complexities, materiality, and pervasiveness of the issues applicable to SFFAS No. 10, the timeliness of the DoD response to its implementation was inadequate and did not ensure accurate and consistent reporting of internal use software.

Management Comments on the Finding and Audit Response

TRICARE Management Activity Comments. The Defense Finance and Accounting Service, as the accountant for TRICARE, identifies the account codes to use for reporting TRICARE obligations and as such, a sentence should be added stating that DFAS is responsible for establishing the proper accounts for recording obligations. Table 1, entitled “Fiscal Year 2001 Information Technology Resources by Components,” is misleading in that it reflected the total Defense Health Program information technology funding and not the portion associated with software development. We recommend that the figures be changed to reflect the Defense Health Program Procurement and Research and Development funding.

TRICARE does not develop its own object class codes. The Defense Finance and Accounting Service provided the object class codes to TRICARE. We recommend that the sentence be changed to say that TRICARE uses the object class codes provided by DFAS.

The report incorrectly stated that TRICARE did not report any costs in the 1720 account that related to research and development of software, only military construction. TRICARE provided DFAS with the obligations and DFAS should have properly posted the information. Copies of the data were provided to the audit team.

For software under development, the statement that the data were not provided is inaccurate. Work-in-progress data were provided to DFAS. The support documents were also provided to the audit team. TRICARE did not calculate the estimate of software under development as shown in Table 3 from the software costs allocated for the Clinical Information Technology Program. This program did not report any software costs. We recommend that the line be eliminated from Table 3.

The sentence that reads “We recommend that the TRICARE Management Activity develop property records to accumulate and report software costs to DFAS,” should be changed to note that DFAS is responsible for providing guidance on how to report software costs.

Where it is stated that DoD Components have not established a cost accounting process to capture material internal costs related to software investment costs, DFAS is responsible for providing that guidance to the DoD Components. The guidance should identify how and what type of software should be used to establish a cost accounting process. The sentence should be modified to reflect that information.

The recommendation that directs DFAS, in conjunction with the DoD Components, to calculate the amount of funds spent through September 30, 2001, for software development should be changed to state that DFAS should provide guidance and reporting standards and a date for the DoD Components to start reporting this information.

Audit Response. Where TRICARE states that the Defense Finance and Accounting Service is responsible, as the accountant for TRICARE, for the associated guidance on accounting for internal use software, in actuality, the Under Secretary of Defense (Comptroller)/Chief Financial Officer is responsible for the guidance. The Defense Finance and Accounting Service is responsible for ensuring that the guidance is implemented consistently throughout DoD. This requires implementing instructions and possibly system development or other changes to comply with the guidance. We have so noted that requirement in our recommendations to the Defense Finance and Accounting Service. No change to the report is necessary.

To clarify what Table 1 represents, we changed the wording of the sentence that precedes the table. We added that the table presents the amounts for information technology to include software and hardware.

We did change the report to state that TRICARE used the object class codes provided by DFAS. TRICARE did provide information to the auditors and DFAS that supported software under development; however, the 1720 account did not reflect that information. DFAS should have properly posted the data to the 1720 account. At the end of each year, DFAS requires an activity to certify that their trial balance accurately reflects its accounting position. When TRICARE received the trial balance for certification, TRICARE should have noted the error in the 1720 account.

Our comments on the property records were taken directly from a prior audit of TRICARE. As a result, to change the wording would improperly reflect how this prior finding was reported.

Recommendations, Management Comments, and Audit Response

A. 1. We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer:

a. Send electronic versions of major changes to guidance to decisionmakers in the DoD functional communities.

b. Develop object class codes to facilitate recording transactions to distinguish between software to be capitalized or expensed. In addition, establish an object class for internally developed software.

c. Establish an in-process account for software in development that follows the U.S. Government Standard General Ledger Chart of Accounts. The account is 1832, "Internal-Use Software in Development." This account should be used to accumulate the costs associated with software in development.

Management Comments. The Under Secretary of Defense (Comptroller)/Chief Financial Officer concurred. The Under Secretary stated that a working group composed of members from the financial management and information technology disciplines of the Military Departments and Defense agencies, as well as the Office of the Inspector General of the Department of Defense are addressing the report's recommendations. The working group's efforts should improve internal use software reporting.

Audit Response. Management comments were responsive. As addressed in Appendix A, the audit team members did participate in the Internal Use Software working group meetings. We limited our participation in the working group to observation and comments on agenda items. We did not make recommendations or vote on any recommendations made by the working group. We do, however, commend the Under Secretary of Defense (Comptroller)/Chief Financial Officer for the initiation of the working group and the progress already made. As stated in the comments from the DoD Components reviewed, definitive guidance on accounting and reporting internal use software is needed.

A. 2. We recommend that the Director, Defense Finance and Accounting Service in conjunction with the DoD Components:

a. Use object class codes established by the Under Secretary of Defense (Comptroller)/Chief Financial Officer to facilitate recording transactions to distinguish between software to be capitalized or expensed.

Management Comments. The Director, Defense Finance and Accounting Service concurred and agreed to use object class codes established by the Under Secretary of Defense (Comptroller)/Chief Financial Officer to improve capitalizing and expensing costs associated with internal use software.

b. Implement a system to capture material internal software costs.

Management Comments. The Director, Defense Finance and Accounting Service concurred and agreed to implement a system to capture material internal software costs upon receipt of guidance from the Under Secretary of Defense (Comptroller)/Chief Financial Officer.

c. Calculate the amount of funds spent through September 30, 2001, for software currently in development that were initiated in prior years and summarize these costs to a construction-in-progress account. Using existing guidance, determine which software should be capitalized and which should be expensed.

Management Comments. The Director, Defense Finance and Accounting Service concurred and in conjunction with the Under Secretary of Defense (Comptroller)/Chief Financial Officer, plan to request the necessary information from the DoD Components using a data call process and a template. Once the responses are received, an Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer task force will review and analyze the responses for reasonableness and support.

Audit Response. We commend the Director, Defense Finance and Accounting Service for the work performed to gather the internal use software information needed to report in the financial statements.

B. Compliance With DoD Guidance on Property Accountability

The DoD Components did not have subsidiary ledgers to support the amounts reported in the general ledger. The lack of ledgers occurred because the DoD Components were not complying with existing requirements to maintain property accountability records for property, plant, and equipment. As a result, the DoD Components did not have the necessary information to correctly report the value of internal use software and to calculate the amount of annual depreciation for the software.

Property Accountability

The DoD Components did not maintain property records for accountable software items (acquisition cost of \$5,000 or higher). The lack of property records occurred because the DoD Components did not follow the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics Draft DoD 5000.nn-M, "Property, Plant, and Equipment Accountability," October 1999 and updated (PP&E manual) and the DoD FMR. As a result, the DoD Components did not have the cost information needed to determine whether a software item had enough accumulated costs to classify as an asset or whether the costs should be expensed.

On January 19, 2000, the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics issued a memorandum directing the DoD Components to implement the PP&E manual even though it had not been finalized. The PP&E manual directs that DoD Components maintain a formal set of PP&E accountable records in an accountability system. At a minimum, a property record should contain the software acquisition date, cost, depreciation interval, and identifying information. According to the PP&E manual,

The DoD Components are required to ensure that government owned or leased PP&E are properly used and maintained and that proper custody, safekeeping, record keeping, and proper final disposal are provided. This includes the responsibility to maintain adequate and complete accountable records with sufficient information to allow DoD financial managers to properly report PP&E information in annual financial statements.

The DoD FMR also requires accountability records for PP&E that meet or exceed the DoD accountability threshold, currently \$5,000. The USD(C/CFO) issued guidance for software reporting in DoD FMR, volume 4, "Accounting Policy and Procedures," chapter 6, "Property, Plant, and Equipment," August 2000. The FMR states that property records should contain sufficient information to control physical quantities, location, and unit cost of PP&E. The property records should be supported by source documents that capture all transactions affecting the investment.

Effective compliance with the provisions of SFFAS No. 10 requires that the DoD Components maintain a subsidiary ledger containing details about cost, acquisition date, depreciation interval, and identifying information for each item of internal use software. A subsidiary ledger is especially important for the calculation of depreciation or when writing off the costs of software that is impaired or withdrawn from use. DoD requirements for maintaining property records for accountable property will provide the required subsidiary ledger information without the time and expense of developing separate subsidiary ledgers for meeting SFFAS No. 10 requirements for financial reporting.

The recommendations in finding A will, if implemented, improve the initial recording of financial transactions using correct transaction codes. The recommendations will also allow for the accumulation of direct and indirect costs for software in development, and the accumulation of amounts to the Internal-Use Software in Development account during development. However, once the payment is made for COTS software or the software in development is completed, the costs must be transferred to a subsidiary account for maintaining the details for effective asset reporting and depreciation calculations. Recording the information required by the PP&E manual in a property accountability system will provide the information necessary for complying with SFFAS No. 10 without the need to develop a separate subsidiary ledger for financial reporting.

Recommendations and Management Comments

B. We recommend that the Director, Defense Finance and Accounting Service, in conjunction with the DoD Components:

1. Comply with the existing DoD regulations, Financial Management Regulation, volume 4, "Accounting Policy and Procedures," chapter 6, "Property, Plant, and Equipment," August 2000, and Draft DoD 5000.nn-M, "Property, Plant, and Equipment Accountability," October 1999 and updated, which require maintaining property accountability records for items (software) over \$5,000.

Management Comments. The Director, Defense Finance and Accounting Service concurred and agreed to comply with existing DoD regulations mandating property accountability.

2. Use the property records as the subsidiary ledger for internal use software. The subsidiary ledger should provide support for reporting the value of software meeting the DoD capitalization threshold and the depreciation expense for that software.

Management Comments. The Director, Defense Finance and Accounting Service concurred and recommended the development of a property system where records are deposited and maintained. This system would also be the subsidiary ledger for all property.

Appendix A. Audit Process

Scope and Methodology

Work Performed. We evaluated the internal controls associated with the reporting of internal use software on the DoD Agency-Wide financial statements in compliance with SFFAS Nos. 6 and 10. We identified the sources the DoD Components used to report internal use software. We evaluated the management controls associated with the flow of software costs through DFAS to the financial statements. During the course of the audit, we met with and gathered information from DFAS, TRICARE Management Activity, WHS, Defense Human Resource Activity, Defense Threat Reduction Agency, Joint Staff, DoDEA, and the Office of the Secretary of Defense.

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 financial management high-risk area.

Use of Computer-Processed Data. To achieve the audit objectives, we did rely on computer-processed data. We used computer-processed data to determine the amounts reported by the DoD Components. The computer-processed data were from the Defense Departmental Reporting Systems, the Washington Headquarters Services Allotment Accounting System, and the Assistant Secretary of Defense (Command, Control, Communications, and Intelligence) database containing materials for justification of the FY 2001 and FY 2002 President's budget request. The systems were used to obtain financial information on internal use software for DoD. We did not test the reliability or accuracy of these systems or databases because the data could be verified outside of the systems. We were able to provide conclusions and recommendations based on the data.

Audit Dates and Standards. We performed this audit from March 2001 through December 2001 in accordance with generally accepted government auditing standards except for the potential personal impairment described below. The audit team members participated in the Internal Use Software working group meetings. The purpose of the working group is to assist DoD Components in implementing SFFAS No. 10, "Accounting for Internal Use Software," October 9, 1998. We limited our participation in the working group to observation and comments on agenda items. We do not make recommendations or vote on any recommendations made by the working group.

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

Management Control Program Review

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 controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We reviewed the adequacy of management controls at the DoD Components with respect to reporting internal use software on the financial statements. Specifically, we reviewed the management controls to ensure that the amounts reported on the financial statements were accurate and that the DoD Components could support the reported numbers. We reviewed the self-evaluations applicable to those controls.

Adequacy of Management Controls. We identified a material management control weakness for the DoD Components we reviewed as defined by DoD Instruction 5010.40. The DoD Components' management controls for reporting the cost of internal use software were not adequate to ensure that the value of software shown on the financial reports and statements was complete and accurate. Recommendations A.1.a., A.1.b., A.1.c., A.2.a., A.2.b., A.2.c., B.1., and B.2., if implemented, will improve the reporting of internal use software on the financial reports. A copy of the report will be provided to the senior official responsible for management controls in the Under Secretary of Defense (Comptroller)/Chief Financial Officer, the Assistant Secretary of Defense (Command, Control, Communications, and Intelligence), and the Defense Finance and Accounting Service.

Adequacy of Management's Self-Evaluation. We reviewed the adequacy of management's self-evaluation. The DoD Components did not identify internal use software as an assessable unit and, therefore, did not identify or report the material management control weakness identified by the audit.

Prior Coverage

General Accounting Office

GAO Report No. AIMD-00-209R "Review of Defense Software Development Best Practices," June 15, 2000

Inspector General of the Department of Defense (IG DoD)

IG DoD Report No. D-2000-128, "Defense Health Program Financial Reporting of General Property, Plant, and Equipment," May 22, 2000

IG DoD Report No. 99-012, "Use of Funds Appropriated for Major Defense Systems," October 14, 1998

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics

Under Secretary of Defense (Comptroller)/Chief Financial Officer

Deputy Chief Financial Officer

Deputy Comptroller (Program/Budget)

Assistant Secretary of Defense (Command, Control, Communications, and Intelligence)

Joint Staff

Director, Joint Staff

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

Director, Department of Defense Education Activity

Director, Washington Headquarters Services

Director, Defense Human Resources Activity

Director, TRICARE Management Activity

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

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)/Chief Financial Officer Comments



COMPTROLLER

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

MAY 22 2002

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

SUBJECT: Inspector General, Department of Defense, Draft Audit Report, "Department of
Defense's Compliance With Internal Use Software Accounting Standards" (Project
No. D2001FH-0079)

This memorandum provides the Office of the Under Secretary of Defense (Comptroller)
(OUSD(C)) response to the subject draft audit report. This office concurs with the
recommendations and is actively working to resolve the identified problems.

As the Inspector General, Department of Defense (IG, DoD) is aware, this office is
chairing a working group comprised of members from the financial management and information
technology disciplines of the Military Departments and Defense Agencies, as well as the IG,
DoD. The working group is addressing the draft report's recommendations and is developing
policy guidance and reengineering business processes. The group's efforts will result in: (1)
interim solutions to improve internal use software reporting and (2) requirements for systems
changes that will be provided to the OUSD(C) Financial Management Enterprise Architecture
(FMEA) Program Management Office to be incorporated in the "to be" architecture of the
FMEA.

My point of contact on this matter is Mr. Mike Powers. Mr. Powers can be contacted by
email at: mike.powers@osd.mil or by telephone at (703) 604-6350.

A handwritten signature in black ink, appearing to read "De W. Ritchie".

De W. Ritchie
Acting Deputy Chief Financial Officer

Defense Finance and Accounting Service Comments



DEFENSE FINANCE AND ACCOUNTING SERVICE

1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291
WWW.DFAS.MIL



MAY 29 2002

DFAS-DAS

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

SUBJECT: Audit Report on Department of Defense's Compliance With Internal Use Software
Accounting Standards (Project No. D2001FH-0079)

Our response to the report is attached. The point of contact is Ms. Heather Wilson,
(703) 607-0750 or DSN 327-0750.


Robert P. McNamara
Director for Accounting

Attachment:
As stated

cc:
DFAS-DDI
DoDIG

**DFAS Comments on Audit Report on Department of Defense's Compliance
With Internal Use Software Accounting Standards (Project No. D2001FH-0079)**

Responses to Recommendations.

Recommendation A.2.a. We recommend that the Director, Defense Finance and Accounting Service, in conjunction with the DoD Components, utilize object class codes established by the Under Secretary of Defense (Comptroller) to facilitate recording transactions to distinguish between software to be capitalized or expensed.

Management Comments. Concur. Upon the development of object class codes to facilitate recording transactions to distinguish between software to be capitalized or expensed by the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)), DFAS in conjunction with DoD Components will utilize applicable guidance to facilitate recording transactions to distinguish between software to be capitalized or expensed.

Estimated Completion Date. October 31, 2002, assuming the updated guidance issued by OUSD(C) is received by October 1, 2002.

Recommendation A.2.b. We recommend that the Director, Defense Finance and Accounting Service, in conjunction with the DoD Components, implement a system to capture material internal software costs.

Management Comments. Concur. Funding and executing budgetary obligations under the object class methodology would facilitate a systems generated approach for capturing internal use software costs. Therefore, upon receipt of updated guidance pertaining to recording transactions to distinguish between software to be capitalized and expensed, the Director, Defense Finance and Accounting Service (DFAS), in conjunction with the DoD Components, will implement a system to capture material internal software costs.

Estimated Completion Date. DFAS will issue the completion date upon coordination with the respective program management office (PMO).

Recommendation A.2.c. We recommend that the Director, Defense Finance and Accounting Service, in conjunction with the DoD Components, calculate the amount of funds spent through September 30, 2001, for software currently in development that were initiated in prior years and summarize these costs to a construction-in-progress account. Using existing guidance, determine that software that should be capitalized and that which should be expensed.

Management Comments. Concur. To comply with the requirements of SFFAS No. 10 for FY 2001, the OUSD(C) in conjunction with DFAS will request the necessary information using a data call process. This process will entail developing a template, and specific guidance on completing the template, that will capture the necessary information. This template should include sections for hardware, software, and services costs. It should split these costs into continuing operations or modernization. It should further divide the software costs into commercial-off-the-shelf applications, contractor developed or internally developed. For internal use software costs, the template should provide for the ability to report costs that should be capitalized and expensed in accordance with SFFAS No. 10. Finally, the template should contain the useful life calculations for capitalized assets so that depreciation can be properly calculated.

This template will be disseminated to the lowest level within the Department of Defense (DoD) with budget authority for information technology costs. Once the responses are received, an OUSD(C) task force will review and analyze the responses to ensure they provide reasonable estimates and supporting documentation for the costs to be capitalized. This analysis will

include a review of the budgetary and or proprietary information from FY 2001. This information will be consolidated at the DoD Reporting Entity level with a Prior Period Adjustment being performed for the FY 2001 information. A similar process should be implemented for FY 2002 and FY 2003, and beginning in FY 2004, this information should be integrated through the budget execution processes.

In FY 2001, the DFAS Working Capital Fund implemented SFFAS No. 10 through a similar process. DFAS reviewed SFFAS No. 10 and determined the impact of these changes on the Agency and drafted preliminary guidance for the implementation of the accounting principle change based on DFAS' interpretation of the standard. DFAS established a central point of contact to organize the distribution of the guidance and the data call to complete a financial statement adjustment for the change in accounting principle. The FY 2001 receipt capitalizations were extracted from the Defense Business Management System and reconciled to the funding authorization for software development and modification funding. The data call was performed to identify agency contacts for reporting internal use software related information for all software initiatives identified in the baseline, utilizing input from agency budgetary contacts as well as identifying DFAS project and system managers. The data call information was summarized into the financial statement adjustment support, and the adjustment was recorded in the Defense Departmental Reporting System.

Estimated Completion Date. DFAS will issue the completion date upon coordination with the respective PMO.

Recommendation B.1. We recommend that the Director, Defense Finance and Accounting Service, in conjunction with the DoD Components, comply with the existing DoD regulations, Financial Management Regulation, volume 4, "Accounting Policy and Procedures," chapter 6, "Property, Plant and Equipment," August 2000, and draft DoD 5000.nn-M, "Property, Plant and Equipment Accountability," October 1999 and updated, which require maintaining property accountability records for items (software) over \$5,000.

Management Comments. Concur. Compliance with existing DoD regulations mandating property accountability records for software items over \$5,000 would require a complete inventory of existing software assets and recording them in a property system for asset maintenance.

Estimated Completion Date. DFAS will issue the completion date upon coordination with the respective PMO.

Recommendation B.2. We recommend that the Director, Defense Finance and Accounting Service, in conjunction with the DoD Components, use the property records as the subsidiary ledger for internal use software. The subsidiary ledger should provide support for reporting the value of software meeting the DoD capitalization threshold and the depreciation expense for that software.

Management Comments. Concur. DFAS recommends the development of a property system where records are deposited and maintained. These records will provide a basis to calculate depreciation based on the information input or the inclusion of these records in DoD's Property Accountability System. This system would be the subsidiary ledger for all property, and proper records and source documentation must be maintained for all items recorded in the property system. DFAS is dependent upon the completion of the findings of the Property, Plant & Equipment PMO within the Office of the Under Secretary of Defense for Acquisition, Technology and Logistics to make system recommendations and selections.

Estimated Completion Date. DFAS will issue the completion date upon coordination with the respective PMO.

Department of Defense Human Resources Activity Comments



DEPARTMENT OF DEFENSE
HUMAN RESOURCES ACTIVITY
HEADQUARTERS
4040 FAIRFAX DRIVE, SUITE 200
ARLINGTON VA 22203-1613

MAY 22 2002

MEMORANDUM FOR DIRECTOR, FINANCE AND ACCOUNTING
DIRECTORATE, DODIG

SUBJECT: Audit Report on Department of Defense's Compliance with Internal Use
Software Accounting Standards (Project No. D2001FH-0079)

The Defense Human Resources Activity (DHRA) has reviewed the subject draft and provides the following comments. DHRA concurs with the recommendation that the Under Secretary of Defense (Comptroller) (USD(C)) issue specific guidance on capitalizing and expensing costs associated with internal use software. Department of Defense Components, in conjunction with the Defense Finance and Accounting Service, would then be able to use the guidance to record transactions and capture material internal software costs.

At present, there is limited guidance and no automated tool available to DHRA to capture and maintain this data. DHRA receives all finance and accounting support through an Inter-service Support agreement with the Defense Logistics Agency. DHRA is working with DFAS to gain access to automated accounting systems that are not yet available to our Field Activity. In addition to access to the systems, an automated system for this property accounting data needs to be developed, tested, and deployed to provide a reliable and efficient tool to meet the requirements. It will be difficult to meet the SSFAS accounting standards without clear guidance and an effective automated property accounting system.

When guidance from USD(C) and DFAS and the necessary automated systems are available, DHRA will work with the Defense Logistics Agency, to develop an approach that will ensure funds expended for internal use software are recorded in accordance with SSFAS guidance. Currently, DHRA tracks resources as part of an existing internal control program. DHRA will review the current evaluation process to determine the benefit of identifying internal use software as an assessable unit.

Thank you for the opportunity to review the draft and provide comments. Amy Talley is my POC for this response and can be reached at (703)696-1013.


Sharon H. Cooper
Assistant Director

Department of Defense Education Activity Comments



DEPARTMENT OF DEFENSE
EDUCATION ACTIVITY
4040 NORTH FAIRFAX DRIVE
ARLINGTON, VIRGINIA 22203-1635

MAY 20 2002

MEMORANDUM FOR INSPECTOR GENERAL, DOD

SUBJECT: Draft Audit Report on "Department of Defense's Compliance With Internal Use Software Accounting Standards (Project No. D2001FH-0079)"

The Department of Defense Education Activity has reviewed the draft audit report, subject as above, and concurs with the report as written.

We appreciate the opportunity to comment on the draft report and commend the DoDIG staff for their professionalism and assistance during the audit.

A handwritten signature in black ink, appearing to read "Joseph D. Tafoya".

Joseph D. Tafoya
Director

TRICARE Management Activity Comments



TRICARE
MANAGEMENT
ACTIVITY

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
HEALTH AFFAIRS
SKYLINE FIVE, SUITE 810, 5111 LEESBURG PIKE
FALLS CHURCH, VIRGINIA 22041-3206

MAY 13 2002

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL

SUBJECT: Draft Report on Audit of DoD's Compliance with Internal Use Software Standards
(Project No. D2001FH-0079)

This is the TRICARE Management Activity's (TMA) response to the recommendations in the Department of Defense Inspector General (IG) Draft Audit Report, "Department of Defense's Compliance With Internal Use Software Accounting Standards," dated March 22, 2002 (Project No. D2001FH-0079).

Overall, we concur with the content of the draft report. As the report identified, clearer guidance needs to be issued by the Defense Finance and Accounting Service (DFAS) for DoD Components to follow in the accounting of software development costs. Since the Defense Health Program (DHP) accounting support is provided by DFAS, we strongly agree that additional guidance and support from DFAS on what software costs should be reported and appropriate tracking is required to enable the DHP financial statements to conform to current regulations.

Attached are our comments on the draft report, which clarify our processes for recording software development costs and our handling of internal use software along with a discussion of shortfalls in DFAS guidance concerning capitalization of software investments.

Please feel free to direct any questions to my project officers on this effort, LtCol Marie Charles (functional) at (703) 681-7731 and Mr. Gunther J. Zimmerman (GAO/IG Liaison) at (703) 681-7889.


Jean Storck
Director, Resource Management

Attachment:
As stated

**DoD IG DRAFT REPORT – DATED MARCH 22, 2002
(D2001FH-0079)**

Agency Comments on Draft Report, “DoD’s Compliance with Internal Use Software Standards”

DEPARTMENT OF DEFENSE COMMENTS

TECHNICAL CHANGES:

- **Page 1. Information Technology Resources.** Second sentence. “The ‘Construction-in-Progress’ account 1720 is the account used to accumulate all software costs. The 1830 account, ‘Information Technology Software,’ is the account to be used to record software as an asset if all cumulative costs exceed the capitalization threshold. Beginning in fiscal year 2002, the ‘Internal-Use Software In Development’ account 1832 will be used in lieu of 1720.”
Comment: DFAS, as the accountant for TMA, identifies the account codes to use for reporting TMA obligations.
Recommendation: The sentence be modified by adding at the end of the current sentence the following: “DFAS provides accounting services to TMA and is responsible for establishing the proper accounts for recording of DHP obligations.”

- **Pages 1 & 2. Fiscal Year 2001 Information Technology Resources by Components.** Table 1 presents the amounts included in the President’s budget for fiscal year 2001 for information technology for all of DoD. “TRICARE – fiscal year 1999; \$807.9M; fiscal year 2000 \$789.0M; and FISCAL YEAR 2001 \$811.5M.
Comment: The TRICARE figures listed in the table are misleading. These figures reflect total DHP Information Technology funding contained in the fiscal year 2001 PB and not the portion associated with software development. Table 1 figures include O&M, Procurement, and Research, Development, Test and Evaluation (RDT&E) funding.
Recommendation: Annotate Table 1 to indicate not all identified funding is associated with software development. Change the TRICARE figures listed to reflect DHP Procurement and RDT&E funding: “TRICARE - fiscal year 1999 \$205.9M; fiscal year 2000 \$178.4M; and fiscal year 2001 \$177.2M.”

- **Page 6. DFAS Guidance.** Fifth sentence. “Once DoD updates the FMR, DFAS is responsible for incorporating the new accounts in its financial reports and for providing procedural guidance to components on what software costs should be reported to DFAS. This may require a new conversion system from the DoD component budget data to the general ledger accounts. DFAS did not provide this guidance to the DoD Components.”
Comment: As the DHP’s accountant, we are reliant upon DFAS guidance and software upgrades to ensure DHP’s obligation data is properly recorded and adheres to the FMR requirements.
Recommendation: It is provided for information only.

Revised

- **Page 7. Washington Headquarters Services Allotment Accounting System.** Third sentence. “The costs were classified, not by general ledger codes, but by four-digit object class codes developed by the DoD Components.”
Comment: The object class codes were given to the DoD Components by DFAS.
Recommendation: Strike “developed by” and replace with “given to the DoD Components by DFAS.”

- **Page 8. First complete paragraph.** “While the DoD FMR establishes groups of object classes, the DoD Components in our audit either established specific object classes or else used the object class codes provided by their accounting entities. The Office of the Secretary of Defense and WHS used the same object classes for recording transactions. TRICARE Management Activity and DoDEA used their own object classes.”
Comment: TMA did not develop the object classes for the recording of software development costs. Instead, we utilized the object classes codes that were provided by DFAS. Specifically, Object Class 2593 Application Software Maintenance/Development was utilized. The Washington Allotment Accounting System (WAAS) (WHS supported system) programs the accounting system to accept specific object classes. TMA utilizes the appropriate object class codes.
Recommendation: Sentence be changed to read “TRICARE Management Activity utilized the object class code provided by DFAS, who as the accountant for the DHP, has the responsibility for providing accounting guidance and support.”

- **Page 8. Capitalized Versus Expenses Codes (cont’d).** First complete paragraph, third sentence. “TRICARE Management Activity and DoDEA used their own object classes.”
Comment: DFAS is responsible to properly post DHP obligations into the proper account in accordance with the FMR. To assist DFAS, TMA provides financial data in a timely manner. Documents were provided to the audit team to support the recording of obligations.
Recommendation: Sentence be changed to read “TRICARE Management Activity utilized object class codes provided by DFAS.”

- **Page 8. Use of Appropriation Codes.** Second paragraph, third sentence, “In fiscal year 2001, the TRICARE Management Activity planned to use the research and development appropriation to account for software costs, but as of the end of our fieldwork, TRICARE did not report any costs in the 1720 account that related to research and development, only Military construction.”
Comment: DFAS is responsible to properly post DHP obligations into the proper account in accordance with the FMR. To assist DFAS, TMA provides financial data in a timely manner. TMA did report RDT&E costs for software development. Copies of the data were provided to the audit team.
Recommendation: Sentence be changed to read “DFAS did not report TMA software development costs in the 1720 account.”

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- **Page 9. Use of the Construction-in-Progress Account.** Sixth paragraph, first sentence, “Because the DoD Components did not account for software in development, we used several means to arrive at the estimated minimum value of unreported software in development costs displayed in Table 3.”
Comment: The statement that data was not provided is inaccurate. Work in progress data was provided to DFAS, who as the TMA accountant, posts the data. The support documents and financial data were provided to the DoD IG audit team.
Recommendation: It is provided for information only.

- **Page 9. Use of the Construction in Progress Account.** Sixth paragraph, fourth sentence, “The TRICARE Management Activity calculated the estimate shown in Table 3 from the software costs allocated for the Clinical Information Technology Program.”
Comment: The Clinical Information Technology Program within TMA did not report an estimate of software in development costs to the audit team. CITPO is one program of many programs associated with software development and thus estimates on all applicable programs is provided to DFAS.
Recommendation: Eliminate the TRICARE line of the Table 3 since it does not accurately depict our activities.

- **Page 10. Property Records.** First complete paragraph, second sentence. “We recommend that the TRICARE Management Activity develop property records to accumulate and report software costs to DFAS.”
Comment: DFAS has the responsibility to provide the guidance and appropriate software options for TMA to report to DFAS the property records information. TMA is ready to comply with the applicable guidance once it is received.
Recommendation: The sentence be changed to read “TMA should report software development costs in the format prescribed by DFAS guidance.”

- **Page 10. Cost Accounting Process.** First paragraph, first sentence. “DoD Components have not established a cost accounting process to capture material internal costs related to software investment costs.”
Comment. As previously stated, DFAS is our accountant. We provide DHP obligation data to DFAS who in turn posts the data. We standby ready to conform to any accounting guidance provided to us by DFAS.
Recommendation: Sentence be modified by adding “DFAS shall provide guidance to the DoD Components that identifies how and with the type of software necessary to establish a cost accounting process.”

- **Page 12. Recommendation A.2.c.** This recommendation directs DFAS, in conjunction with the DoD Components, to “calculate the amount of funds spent through September 30, 2001, for software currently in development that were initiated in prior years and summarize these costs to a construction-in-progress account. Using existing guidance, determine that software that should be capitalized and that which should be expenses.”
Comment: Guidance and a reporting standard needs to be established by DFAS to ensure that all DoD Components report data uniformly.

Recommendation: Sentence be changed to read "DFAS should provide guidance and a reporting standard for the DoD Components to report funds spent on development." DFAS also should establish a date for all DoD Components to begin reporting this information.

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