

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

**PRESENTATION OF ACCRUED ANNUAL LEAVE IN THE
FY 1996 DEFENSE AGENCY FINANCIAL STATEMENTS
OF THE DEFENSE BUSINESS OPERATIONS FUND**

Report No. 97-224

September 30, 1997

Department of Defense

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Acronyms

DBMS	Defense Business Management System
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
MTMC	Military Traffic Management Command
OMB	Office of Management and Budget
TRANSCOM	U.S. Transportation Command



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



September 30, 1997

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
COMMANDER, U.S. TRANSPORTATION COMMAND
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on the Presentation of Accrued Annual Leave in the
FY 1996 Defense Agency Financial Statements of the Defense
Business Operations Fund (Report No. 97-224)

We are providing this report for your information and use. We reviewed how the Defense agencies and the Defense Finance and Accounting Service present accrued annual leave on their financial statements as part of an overall audit of liabilities accounts in the FY 1996 Defense Business Operations Fund financial statements. Financial statements are required by the Chief Financial Officers Act of 1990, as amended. This is the second in a series of reports dealing with Defense Business Operations Fund liability issues. We considered management comments on a draft of this report in preparing the final report.

The Defense Finance and Accounting Service comments conformed to the requirements of DoD Directive 7650.3; therefore, additional comments are not required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Richard B. Bird, Audit Program Director, at (703) 604-9145 (DSN 664-9145) or Mr. Jack L. Armstrong, Audit Program Manager, at (317) 542-3846 (DSN 699-3846). See Appendix C for the report distribution. The audit members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 97-224

September 30, 1997

(Project No. 5FI-2017.01)

Presentation of Accrued Annual Leave in the FY 1996 Defense Agency Financial Statements of the Defense Business Operations Fund

Executive Summary

Introduction. This is the second of a series of audit reports related to the "Audit of Liabilities on the FY 1996 Consolidated Financial Statements of the Defense Business Operations Fund." The first report determined that accounting records supporting \$216.7 million in unliquidated obligations balances for the Defense Fuel Supply Center were inaccurate. This report discusses the presentation of accrued annual leave on the Defense agencies financial statements and related disclosures. The final report will address internal controls over and compliance with laws and regulations pertaining to the liability accounts for the Defense Business Operations Fund.

The Chief Financial Officers Act of 1990, as amended, requires that DoD prepare financial statements covering each fiscal year's financial activity. In addition, footnotes to the principal statements should provide the additional disclosures necessary to make the principal statements fully informative and not misleading. In FY 1996, DoD reported a total of \$897.1 million in accrued annual leave on the Statement of Financial Position. The Defense agencies reported \$222.4 million in accrued annual leave, or 25 percent of the total DoD reported accrued leave.

In December 1996, the Under Secretary of Defense (Comptroller) announced that the Defense Business Operations Fund would be realigned into several working capital funds. This realignment does not affect the matters discussed in this report.

Audit Objectives. The overall audit objective was to determine whether the liability accounts on the FY 1996 Defense Business Operations Fund consolidated financial statements are presented fairly in accordance with other comprehensive basis of accounting described in Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, or subsequent issuances. We also assessed internal controls and compliance with laws and regulations. As part of that objective, we evaluated how the Defense agencies presented the accrued leave account on the FYs 1994, 1995, and 1996 Statements of Financial Position. Specifically, this report discusses inconsistencies in the presentation of accrued civilian annual leave on the FYs 1994 and 1995 financial statements and related disclosures and the probability of incorrect presentation of accrued civilian annual leave on the FY 1996 financial statements.

Audit Results. Accrued annual leave was incorrectly presented as unfunded on the Statement of Financial Position, and the footnotes were inaccurate on the Defense Finance and Accounting Service, Defense Logistics Agency, and U.S. Transportation

Command Defense Business Operations Fund financial statements. This resulted in the inconsistent reporting of accrued leave on the FYs 1994, 1995, and 1996 financial statements and reduced their comparability and usefulness. In addition, for FY 1996:

- o funding requirements were overstated by \$55.8 million, and
- o liabilities on the Statement of Financial Position were inaccurate.

For details of audit results, see part I. The management controls that we reviewed were effective in that no material management control weaknesses were identified. See Appendix A for details on the management control program.

Summary of Recommendations. We recommend the Director, Defense Finance and Accounting Service, correct the Defense Finance and Accounting Service financial statements and determine how much of the accrued leave liability is funded and unfunded.

Management Comments. The Deputy Director for Accounting, Defense Finance and Accounting Service, concurred with the finding and recommendation, stating that DFAS will research and identify the accurate amounts of funded and unfunded accrued annual leave liability to be reported in the FY 1997 financial statements. All actions should be completed by November 1997. See Part I for a complete discussion of the management comments and Part III for the complete text of the management comments.

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Part I - Audit Results

Audit Background

This is the second of a series of audit reports related to the "Audit of Liabilities on the FY 1996 Consolidated Financial Statements of the Defense Business Operations Fund (DBOF)." The first report determined that accounting records supporting \$216.7 million in unliquidated obligations balances for the Defense Fuel Supply Center were inaccurate. This report discusses the presentation of accrued annual leave on the Defense agencies financial statements and related disclosures. The final report will address internal controls over and compliance with laws and regulations pertaining to the liability accounts for DBOF. In December 1996, the Under Secretary of Defense (Comptroller) announced that the DBOF would be broken out into several separate working capital funds. This realignment does not affect the matters discussed in this report.

Chief Financial Officers Act. The Chief Financial Officers Act of 1990 (Public Law 101-576, November 15, 1990) as amended by the Federal Financial Management Act of 1994 (Public Law 103-356, October 13, 1994) requires DoD to prepare annual, audited financial statements covering each fiscal year's financial activity. The Federal Financial Management Act of 1994 also requires that Government-wide financial statements be prepared annually beginning in FY 1997.

Financial Statements. "DoD Guidance on Form and Content of Financial Statements for FY 1994 and FY 1995" states that the DoD Components within the DBOF have been made reporting subentities. Defense agencies as the Defense Logistics Agency (DLA) and the U.S. Transportation Command (TRANSCOM) are considered DoD Components. As such, these organizations must have a complete set of financial statements for their portion of the DBOF operations. A complete financial statement must include the overview of the reporting entity, principal financial statements and related footnotes, and supplemental financial management information. The footnotes are an integral part of the financial statements and should be used to disclose additional information necessary to make the principal statements fully informative. The footnotes should also clarify the accrued leave amounts shown on the Statement of Financial Position.

Preparation of Financial Statements. The Defense Finance and Accounting Service (DFAS) is responsible for preparing the financial statements for the Military Departments and the Defense agencies. DFAS operates and maintains the financial accounting systems and is responsible for the continued integrity of the information after it is entered into the system. The Military Departments and Defense agencies are responsible for the integrity of the data entered into the accounting systems and must review the financial statements for accuracy.

Accrued Annual Leave. Annual leave that has been earned but has not been used is an accrued liability. Accrued annual leave amounts are shown on the Statement of Financial Position, one of the principal financial statements. The

annual leave balance at the end of the fiscal year is reflected at current pay rates and shown as a liability on the financial statements. Accrued annual leave may be either unfunded or funded by budget resources. Unfunded accrued annual leave is leave that has been earned and is expected to be paid from future years' appropriations. Funded accrued annual leave is leave that has been earned and is expected to be paid in the future and recovered through DBOF revenues.

In FY 1996, DoD reported a total of \$897.1 million in accrued annual leave. The Defense agencies reported \$222.4 million in accrued annual leave, or 25 percent of the total DoD reported accrued leave. Table 1 shows the accrued annual leave on the Defense agencies Statement of Financial Position for FYs 1995 and 1996.

<u>Defense Agency</u>	<u>FY 1996 (millions)</u>	<u>FY 1995 (millions)</u>
Defense Commissary Agency	\$ 28.2	\$ 27.2
Defense Finance and Accounting Service	56.1	55.6
Defense Information Systems Agency	23.0	20.9
Defense Logistics Agency	96.5	97.8
Joint Logistics Support Center	4.1	1.3
U.S. Transportation Command	<u>14.5</u>	<u>13.4</u>
Totals	\$222.4	\$216.2

Audit Objectives

The overall audit objective was to determine whether the liabilities accounts contained in the FY 1996 DBOF consolidated financial statements are presented fairly in accordance with other comprehensive basis of accounting described in Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, or subsequent issuances. We assessed internal controls and compliance with laws and regulations as they related to the presentation of accrued annual leave on the financial statements.

As part of that objective, we evaluated how the DFAS presented the accrued annual leave account on the FYs 1994, 1995, and 1996 financial statements. Specifically, this audit report discusses inconsistencies in the presentation of accrued civilian annual leave on the financial statements and related disclosures and the probability of incorrect presentation of accrued civilian annual leave on the FY 1996 financial statement. Appendix A discusses audit scope and methodology and our review of the management control program. Appendix B summarizes prior audits and other reviews related to the audit objective.

Presenting Accrued Civilian Annual Leave on the Financial Statements

Accrued annual leave was incorrectly presented as unfunded on the Statement of Financial Position, and the footnotes were inaccurate on the DFAS, DLA, and TRANSCOM DBOF financial statements. These Defense agencies did not comply with the reporting requirements contained in OMB and DoD regulations. This resulted in the inconsistent reporting of accrued leave on the FYs 1994, 1995, and 1996 financial statements and reduced their comparability and usefulness. In addition, for FY 1996:

- o funding requirements were overstated by \$55.8 million; and
- o liabilities on the Statement of Financial Position were inaccurate.

Criteria for Presentation of Accrued Leave

According to public law, the DoD Financial Management Regulation, and OMB and DoD form and content guidance for financial statements, annual leave should be expensed as taken and earned, but the unused portion should be accrued as a liability. OMB and DoD form and content guidance explain the preparation and use of footnotes to the financial statements. DFAS headquarters also provided procedures for reviewing the quality of information on financial statements.

Title 31, United States Code, section 3512(b). According to public law, "...the head of each executive agency shall maintain the accounts of the agency on an accrual basis to show the resources, liabilities, and costs of operations of the agency."

DoD Financial Management Regulation. DoD 7000.14-R, "DoD Financial Management Regulation," Volume 11B, "Reimbursable Operations, Policy and Procedures Defense Business Operations Fund," states:

Account 2215, "Accrued Payroll - Funded Annual Leave - Civilian," shall be established to account for accrued annual leave of DBOF civilian employees. A factor for annual leave accrual should be included within the stabilized rate or price charged by a DBOF activity. The stabilized rates or prices, therefore, provide funding for annual leave.

Office of Management and Budget. OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," states that the footnotes to the principal financial statements are an integral part of the principal statements and

Presenting Accrued Civilian Annual Leave on the Financial Statements

must provide the additional disclosures necessary to make the principal financial statements fully informative and not misleading.

DoD Form and Content of Financial Statements. Funded accrued leave for civilians that has been earned and is expected to be paid in the future should be presented in the financial statement as “Annual Accrued Leave” under “Accrued Payroll and Benefits,” according to “DoD Guidance on Form and Content of Financial Statements for FY 1994 and FY 1995” (Appendix 3-B).

DoD form and content guidance states the following regarding footnotes to the financial statements.

In many cases the underlying financial systems and operations that produce these statements were not designed to generate auditable financial statements in compliance with form and content. The continuing system problems realistically will require a number of years to correct. In cases where the data for individual line items cannot be captured, or a substitution is made from the requirements, the deficiencies will be explained and the reason for noncompliance annotated in footnotes. The reporting entity will explain the reason such information is not available and will discuss their plans for meeting these reporting requirements in the immediate, succeeding and future years.

In addition, the DoD form and content guidance requires 30 footnotes within the financial statements. These footnotes clarify data for various accounts contained in the financial statements, such as Other Liabilities, Federal and Non-Federal, Debt, Other Revenue and Financial Sources, and Other Expenses. At a minimum, the footnotes should identify the specific transactions that make up these accounts. Additional footnotes may be added to make other disclosures as needed.

DFAS Headquarters Guidance. DFAS Headquarters, in its October 18, 1996, memorandum, “Standard Requirements and Reference Information for Fiscal Year (FY) 1996 Chief Financial Officers (CFO) Reports,” provided guidance for improving the quality of information on the statements. Specifically, DFAS Centers were to ensure that all amounts reported on the financial statements were in accordance with DoD accounting guidance and that amounts in the statements and footnotes agreed.

Accrued Leave Presentation

For FY 1996, DFAS improperly presented \$55.8 million in civilian accrued annual leave as unfunded. Also, \$162.9 million of accrued annual leave was incorrectly presented as unfunded on the DFAS, DLA, and TRANSCOM DBOF Statements of Financial Position for FY 1995. The footnotes to the DBOF financial statements did not provide the information necessary to clarify the accrued leave transactions reported on the Statement of Financial Position. However, DLA and TRANSCOM corrected their FY 1996 financial statements. The Defense Commissary Agency, Defense Information Systems Agency, and

Presenting Accrued Civilian Annual Leave on the Financial Statements

Joint Logistics Systems Command correctly reported civilian accrued annual leave on their financial statements. Table 2 shows the amount of unfunded accrued leave reported.

<u>Defense Agency</u>	<u>FY 1996 Amount (millions)</u>	<u>FY 1995 Amount (millions)</u>
DFAS*	\$55.8	\$ 55.6
DLA	0	97.8
TRANSCOM	0	9.5
Total	\$55.8	\$162.9

*DFAS could not determine amount that could be properly presented as unfunded.

We brought the discrepancies to the attention of DFAS, DLA, and TRANSCOM management and discussed the required corrective action. DLA and TRANSCOM took action and corrected the FY 1996 financial statements, potentially avoiding \$107.3 million in misstatements and future invalid billings to its customers and DoD. DFAS did not correct its FY 1996 financial statements.

The Defense Finance and Accounting Service. In FYs 1995 and 1996, DFAS reported total accrued annual leave of \$55.6 million and \$56.1 million, respectively. DFAS improperly presented \$55.6 million and \$55.8 million in civilian accrued annual leave as unfunded in its FY 1995 and FY 1996 financial statements, respectively. Expensed civilian annual leave should be accounted for and reported as funded. Expensed leave should remain separate from the unfunded amounts received through capitalization. However, the financial statement account "Other Non-Federal Liabilities Not Covered by Budgetary Resources" contains both funded and unfunded accrued annual civilian leave. This account is only appropriate for unfunded leave; however, DFAS has continued to accrue its expensed annual civilian leave in this account.

Capitalized Accrued Leave. DFAS could not determine how much of its accrued annual leave should be reported as funded or unfunded. During the capitalization process, DFAS inherited accrued annual leave from capitalized agencies without receiving the corresponding funding for accrued annual leave. DFAS was unable to produce documentation supporting the original amount of the accrued annual leave or portion that should be reported as funded. According to DoD 7000.14-R, accrued annual leave acquired as a result of capitalization and not accompanied by the funds must be reported as unfunded. The unfunded leave account should have decreased not have increased in FY 1996. As leave is taken it is charged against the unfunded leave until the unfunded accrued leave account is reduced to zero. As a result, DFAS lost

Presenting Accrued Civilian Annual Leave on the Financial Statements

accountability over the actual amount of unfunded leave and overstated future funding requirements.

Footnote Disclosure. Footnote number 30 stated that the Defense Business Management System (DBMS) did not accommodate the establishment of accrued annual leave in accordance with OMB and DoD policy because of a system deficiency. OMB and DoD policy stated that the reporting entity will discuss its plans for meeting financial reporting requirements. The DFAS did not explain how or when it was going to correct the DBMS system problem.

The Defense Logistics Agency. The DLA avoided misstating its FY 1996 financial statements by correcting reporting errors made in prior years. The DLA FY 1995 financial statement incorrectly presented \$97.8 million in accrued annual leave as a future funding requirement because it did not convert the accrued leave to the proper DoD account. DLA expenses its annual leave as taken. Because DLA is a DBOF activity and current-year accrued annual leave is expensed, it recovers the expense in customer billings. When the current-year annual leave is expensed and accrued as an unfunded liability, a future funding requirement is recognized. Accrued annual leave should be presented as funded, and no future funding requirement should exist. However, footnotes indicating the amount of accrued leave may be understated.

Reporting Compatibility. DLA personnel stated accrued annual leave was reported as unfunded because the DBMS did not contain a General Ledger Account Code for funded annual leave. DoD 7000.14-R has an account code for funded accrued annual leave as specified by the U.S. General Ledger. DBOF organizations may accumulate financial information using the account codes in their current systems but ultimately must convert the DBMS account codes into the DoD account codes. DLA did not convert the amount of unfunded accrued annual leave under the DBMS account code to the DoD 7000.14-R account code.

Footnote Disclosures. Footnote 1 to the DLA financial statement summarizes the significant accounting policies affecting financial statement information. According to the footnote, DLA understated accrued annual leave reported on line 5.a. (Transactions With Federal Entities, Not Covered by Budgetary Resources) in the FY 1994 Statement of Financial Position by \$100,000 to \$200,000. The footnote attributed the understatement to not including accrued leave for DLA personnel assigned to overseas activities. However, line 5.a. does not address accrued annual leave. Accrued annual leave is included in line 5.b.5. (Transactions With Non-Federal Entities, Covered by Budgetary Resources). Furthermore, the understatement was not discussed in the FY 1995 financial statement footnotes. Therefore, the footnote does not disclose the status of the understatement.

The FY 1994 Statement of Financial Position, line 5.b.5, also reflected \$274.7 million in liabilities; however, only \$207.9 million was accounted for by footnote 17 to the DLA financial statements. Footnote 17 identifies intragovernmental liabilities (current and noncurrent) and governmental accrued

Presenting Accrued Civilian Annual Leave on the Financial Statements

annual leave (current and noncurrent) under Other Non-Federal Liabilities Not Covered by Budgetary Resources. The \$66.8 million difference was not identified or explained in footnote 17.

The U.S. Transportation Command. The TRANSCOM avoided misstating its FY 1996 financial statements by correcting an error made in FY 1995. TRANSCOM reported a total of \$13.4 million in civilian accrued annual leave on the FY 1995 financial statements. However, \$9.5 million was reported as unfunded even though all accrued leave was reported as funded in the FY 1994 financial statements. This discrepancy was not explained in the related footnotes, which creates an inconsistency in the Statement of Financial Position for FYs 1994, 1995, and 1996. The error reduces the usefulness of the information to the user of the financial statements.

Reported Accrued Leave. The TRANSCOM financial statement includes the Airlift Mobility Command, the Military Sealift Command, and the Military Traffic Management Command (MTMC). The unfunded annual leave was attributed to MTMC. Initially, when MTMC submitted its trial balances to TRANSCOM, accrued leave was reported as unfunded. MTMC recognized that it had mistakenly reported accrued annual leave as unfunded and had requested TRANSCOM to correct the entry. However, TRANSCOM did not correct the entry.

Footnote Disclosure. The FY 1995 Statement of Financial Position for TRANSCOM shows a \$9.5 million unfunded accrued annual leave balance; however, funded accrued annual leave was reported in FY 1994. The footnotes did not explain why the accrued annual leave for MTMC had changed from funded to unfunded. Because the error was corrected on the FY 1996 Statement of Financial Position, footnote disclosure was not required.

Conclusion

In appropriated fund accounting, unfunded liabilities are reported in the Statement of Financial Position as future funding requirements and offset as a reduction to the equity balances. This treatment is inappropriate in DBOF accounting because the accrued annual leave has been expensed and will be recovered in the cost of goods or services provided to DBOF customers. Consequently, additional funds are not needed for expensed accrued leave in DBOF, and financial statements should not reflect future funding requirements.

While the amount of accrued annual leave reported as unfunded may be quantitatively immaterial, it could have a material impact on the quality of financial statements. Financial statements and related footnotes must be complete, accurate, and adequately inform the readers of the true nature of the accounts. Misleading or incorrect financial statements could adversely affect management decisions. By making the adjustments discussed in "Corrective Action," and correcting the DFAS accrued leave account, future financial statements will be more accurate.

Recommendations and Management Comments

We recommend that the Director, Defense Finance and Accounting Service, determine how much DFAS accrued annual leave liability should be reported as funded or unfunded, document the amounts, and correct the account balance for the FY 1997 financial statement.

Management Comments. The Deputy Director for Accounting, Defense Finance and Accounting Service, concurred with the finding and recommendation, stating that DFAS will research and identify the accurate amounts of funded and unfunded accrued annual leave liability to be reported in the FY 1997 financial statements. All actions should be completed by November 1997.

Part II - Additional Information

Appendix A. Audit Process

Scope

As part of an overall audit of liabilities accounts contained in the FY 1996 DBOF financial statements, we reviewed the presentation of accrued annual leave on the FYs 1994 and 1995 Defense agency financial statements. We also reviewed the FY 1996 financial statement without the footnotes. Specifically, we reviewed the Statement of Financial Position and related footnotes, concentrating on accrued annual leave. Our review was limited to the financial statements of the Defense agencies because the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency were assigned the responsibility for auditing the financial statements of the Military Departments.

In analyzing how the DFAS Centers presented data on the financial statements, we found that the Defense agencies reported accrued annual leave as unfunded, and the Military Departments reported accrued leave as a funded liability. As a result we focused our review on presentation of Defense agency accrued leave on the financial statements.

Total liabilities reported on the DoD DBOF Consolidated Statement of Financial Position were \$20.3 billion in FY 1995 and \$18.4 billion in FY 1996. Of these amounts, \$5.6 billion (28 percent) in FY 1995 and \$5.2 billion (26 percent) in FY 1996 were for the Defense agencies. On the Statements of Financial Position, funded and unfunded accrued annual leave totaled \$911.9 million in FY 1995 and \$897.1 million in FY 1996. Of these amounts, \$216.2 million (24 percent) in FY 1995 and \$222.4 million (25 percent) in FY 1996 were for the Defense agencies.

Methodology

Defense Agency Review. We reviewed DoD 7000.14-R and Form and Content guidance for preparing the annual Statement of Financial Position as required by the Chief Financial Officers Act. We limited our review to how the DFAS Centers used the financial data in the DoD standard general ledger accounts to prepare the Defense agency financial statements. The Defense agency statements are compiled at three DFAS Centers and are consolidated at DFAS Indianapolis Center. The table that follows identifies the DFAS Centers that prepared financial statements and accounting reports for the Defense agencies that we reviewed.

DFAS Centers Responsible for Preparing DBOF Financial Statements			
<u>Defense Agency</u>	<u>DFAS- Columbus</u>	<u>DFAS- Denver</u>	<u>DFAS- Cleveland</u>
Defense Commissary Agency	X		
Defense Finance and Accounting Service	X		
Defense Information Systems Agency			X
Defense Logistics Agency	X		
Joint Logistics Support Center		X	
U.S. Transportation Command		X	

We interviewed personnel at the DFAS Centers at Columbus, Denver, and Indianapolis to determine how they applied the guidance relating to the compiling and presenting of accrued annual leave in the Statement of Financial Position and related footnotes. We reviewed the process used by the DFAS Indianapolis Center personnel for consolidating the information from the individual financial statements into the consolidated DBOF financial statements. The presentation of accrued annual leave on the Statement of Financial Position was also discussed with DFAS headquarters, DLA, TRANSCOM, and Under Secretary of Defense (Comptroller) personnel. We requested copies of supporting documentation for accrued leave and calculation of DBOF billing rates.

Use of Computer-Processed Data. We reviewed the financial data used by DFAS Center personnel to prepare and compile the DBOF Statement of Financial Position. The data originated from various financial accounting systems. Although we relied on the financial statements, we did not test the reliability of the computer-processed data used to prepare the statements as it was not essential for examining their presentation of liabilities. The problems discussed in this report was not the result of the use of computerized-processed data.

Audit Period and Standards. We performed this financial-related audit from June 1995 through March 1997 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included such tests of management controls as were considered necessary.

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

Management Control Program

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987,* requires 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 the controls.

Scope of Review of the Management Control Program. We reviewed management controls over the presentation of civilian accrued annual leave on the financial statements. We also reviewed the results of any self-evaluation of those management controls. Because we did not identify a material weakness, we did not assess management's self-evaluation.

Adequacy of Management Controls. The DFAS management controls that we reviewed were adequate in that we identified no material management control weaknesses.

*DoD Directive 5010.38 has been revised as "Management Control Program," August 26, 1996. The audit was performed under the April 1987 version of the directive.

Appendix B. Prior Audits and Other Reviews

We identified prior audits by the Inspector General, DoD, Army Audit Agency, and Naval Audit Service discussing issues related to accounting for and reporting accrued annual leave.

Inspector General, DoD

Inspector General, DoD, Report No. 94-035, “Financial Reporting Procedures for Defense Distribution Depots-Defense Logistics Agency Business Area of the Defense Business Operations Fund,” February 18, 1994. This audit disclosed material inaccuracies in the distribution depot asset and liability accounts. In addition, it identified a lack of adequate procedures, controls, and accounting systems for producing reliable financial statements. The report states that the unfunded liability account of \$23.5 million for accrued annual leave was significantly understated, and the account did not include balances for 20 of the 30 DLA distribution depots reviewed. The report does not provide a calculation of the understatement nor contain recommendations for including all balances in the accrued annual leave account.

Army Audit Agency

Army Audit Agency Report No. NR 94-454, “Defense Business Operations Fund, Depot Maintenance, Army FY 1992 Financial Statement,” March 30, 1994. The report states that the Maintenance organizations that used the Standard Depot System did not accurately accrue annual leave, payroll, and benefits at the end of FY 1992. Liabilities for accrued leave, payroll, and benefits were understated because the system did not accrue annual leave for partial pay periods, and alternate work schedules or overtime and other premium pay used to compute accrued payroll and benefits were not considered. The amount of the understatement was about \$5.4 million. In addition, about \$12.5 million of military payroll and annual leave was misclassified. Recommendations were made to adjust the financial statements to correct the understatements in accruals. Also, the report recommended that depot maintenance activities with unique accounting systems establish a general ledger account to report annual leave. The Army Materiel Command agreed to give the DFAS Indianapolis Center the dollar value of the understatement so that a determination could be made, based on materiality, of its inclusion in FY 1993 reports. The Army Materiel Command also agreed that annual leave should be reported under a separate general ledger account; it did not set milestone dates for the completion of corrective actions.

Naval Audit Service

Naval Audit Service Report No. 044-95, "Fiscal Year 1994 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund," May 30, 1995. The report states that the Navy DBOF organizations had a net understatement of \$15.4 million reported in their accrued payroll and benefits account balances. Inaccuracies occurred due to prorating problems, confusion regarding guidance, and insufficient management oversight. The report recommended that guidance on accruing annual leave for the end of the fiscal year be clarified to ensure accuracy and consistency on financial statements. Also, the report recommended the Naval Supply Systems Command require its activities to use DBMS to report year-end accrued annual leave balances for inclusion in the financial statements. The Navy Supply Systems Command concurred with the recommendation, stating that it would instruct DBMS activities to implement the procedures for including accrued annual leave balances in the financial statements upon receiving guidance from DFAS regarding the correct reporting procedures.

Appendix C. Report Distribution

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Appendix C. Report Distribution

Non-Defense Federal Organizations and Individuals

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Committee on Government Reform and Oversight
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House Committee on National Security

Part III - Management Comments

Defense Finance and Accounting Service Comments



DFAS-HQ/AFC

DEFENSE FINANCE AND ACCOUNTING SERVICE

1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291

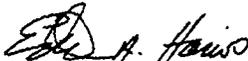
AUG 29 1997

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

SUBJECT: Audit Report on the Presentation of Accrued Annual
Leave in the FY 1996 Defense Agency Financial
Statements of the Defense Business Operations Fund
(Project No. 5FI-2017.01)

Our comments to the subject report are attached.

If you have any questions, please contact Mr. Robin Ho
on (703) 607-1135.


Edward A. Harris
Deputy Director for
Accounting

Attachment:
As stated

cc:
DFAS-HQ/PA
DFAS-HQ/C
DFAS-HQ/ADE
DFAS-CO-AC

Defense Finance and Accounting Service Comments

SUBJECT: Audit Report on the Presentation of Accrued Annual Leave in the FY 1996 Defense Agency Financial Statements of the Defense Business Operations Fund (Project No. SFI-2017.01)

Recommendation: We recommend that the Director, Defense Finance and Accounting Service, determine how much DFAS accrued annual leave liability should be reported as funded or unfunded, document the amounts, and correct the account balance for the FY 1997 financial statement.

DFAS Response: Concur. For FY 1997, DFAS will research to identify the accurate amounts of funded and unfunded accrued annual leave liability to be reported in the FY 1997 financial statements.

Estimated Completion Date: November 1997.

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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