

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

**A STATUS REPORT ON THE MAJOR ACCOUNTING
AND MANAGEMENT CONTROL DEFICIENCIES IN THE
DEFENSE BUSINESS OPERATIONS FUND FOR FY 1996**

Report No. 98-002

October 3, 1997

Department of Defense

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Acronyms

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
IMAS	Interim Migratory Accounting Strategy
PP&E	Property, Plant, and Equipment
USD(C)	Under Secretary of Defense (Comptroller)



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October 3, 1997

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

**SUBJECT: A Status Report on the Major Accounting and Management Control
Deficiencies in the Defense Business Operations Fund for FY 1996
(Report No. 98-002)**

We are providing this report for review and comment. We considered management reports on a draft of this report in preparing the final report.

The Under Secretary of Defense (Comptroller) comments were partially responsive. The Deputy Chief Financial Officer agreed that accounting and management control deficiencies should be reviewed by his office and the Defense Finance and Accounting Service, but disagreed with our recommendation to conduct reviews similar to the FY 1997 Defense Working Capital Fund Study. DoD Directive 7650.3 requires that all recommendations be resolved promptly. We request that the Under Secretary of Defense (Comptroller) reconsider its position and provide additional comments on the final report by November 28, 1997.

The courtesies extended to the audit staff are appreciated. Questions on the audit should be directed to Mr. David F. Vincent, Audit Program Director, at (703) 604-9110 (DSN 664-9110), or Mr. Thomas J. Winter, Audit Project Manager, at (703) 604-9134 (DSN 664-9134). See Appendix E for the report distribution. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. 98-002

(Project No. 5FH-2015.02)

October 3, 1997

A Status Report on the Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund for FY 1996

Executive Summary

Introduction. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires an annual audit of the financial statements of trust and revolving funds, such as the Defense Business Operations Fund. The Defense Business Operations Fund was established as a revolving fund in FY 1992 and consisted of business areas such as Supply Management and Depot Maintenance. In December 1996, the Under Secretary of Defense (Comptroller) announced that the Defense Business Operations Fund would be eliminated and separate working capital funds would be established. Under the working capital fund concept, each Component or Defense agency will be responsible for managing the operational and financial aspects of its working capital funds. The changed structure of the Defense Business Operations Fund has no effect on the management control weaknesses discussed in this report. The reader of this report should substitute "Defense Working Capital Funds" for "Defense Business Operations Fund" whenever appropriate.

The Under Secretary of Defense (Comptroller) initiated a comprehensive review of the Defense Business Operations Fund in response to a requirement in the FY 1997 Defense Authorization Act to provide Congress a plan for improving the management and performance of the Defense Business Operations Fund. This review, known as the Defense Working Capital Funds Study, involves participants drawn from all Military Departments and Defense agencies and includes Defense Business Operations Fund employees and customers. The FY 1996 Defense Business Operations Fund financial statements identified assets of \$92.2 billion, liabilities of \$18.4 billion, and revenues of \$73.7 billion.

Audit Objectives. The objective of the audit was to identify and summarize the Defense Business Operations Fund's major accounting and management control deficiencies that prevented the timely development and reliable presentation of its financial statements. This status report provides a global perspective of the significant systemic management control problems that affected the Defense Business Operations Fund.

Audit Results. We identified significant accounting and management control deficiencies in the Defense Business Operations Fund that prevented the timely development and reliable presentation of the financial statements. The areas in which deficiencies were identified are grouped within the major categories making up an organization's management control structure:

- accounting systems:
 - Interim Migratory Accounting Strategy,
 - cash management,
 - standard general ledger, and
 - documentation and audit trails;
- control procedures;
- control environment:
 - property, plant, and equipment,
 - valuation and reporting of inventory, and
 - personnel.

The problems that we identified affected approximately 67.8 percent of total assets and 16.6 percent of total revenues. The deficiencies resulted in auditor-recommended adjustments of \$75.1 billion to the FY 1996 financial statements and the supporting accounting records. Many of the deficiencies noted in last year's report remain uncorrected, as candidly acknowledged by the Under Secretary of Defense (Comptroller) in his Management Representation Letter. See Part I for a discussion of the audit results.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) conduct periodic reviews of all issues affecting the Defense Working Capital Funds. The reviews should be similar to the FY 1997 Defense Working Capital Funds Study initiated by the Under Secretary of Defense (Comptroller) in response to the FY 1997 Defense Authorization Act. The focus should be on continuous process improvement.

Management Comments. The Deputy Chief Financial Officer partially concurred with our recommendation, stating that although accounting and management control deficiencies should be reviewed by his office and the Defense Finance and Accounting Service, he believed the recommendation to conduct reviews similar to the FY 1997 Defense Working Capital Fund Study would result in reviews that are too formal and structured. He further stated that such reviews would not be necessary, or effective, and could require the expenditure of resources out of proportion to the expected benefits. The Deputy Chief Financial Officer indicated that quarterly budget reviews and other meetings with representatives of the Military Departments and the Defense agencies are adequate to discuss accounting issues and propose solutions. See Part I for a complete discussion of the management comments and Part III for the complete text of the management comments.

Audit Response. The management comments are partially responsive. We continue to believe that a structured approach specifically dedicated to addressing accounting and management control deficiencies associated with Working Capital Funds would be an excellent method to help correct systemic weaknesses. Also, based on management's comments, we made changes to the report where appropriate. We request the Under Secretary of Defense (Comptroller) reconsider its position and provide additional comments on the final report by November 28, 1997.

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Part I - Audit Results

Audit Background

The Chief Financial Officers Act, as amended, requires an annual audit of financial statements for revolving funds such as the Defense Business Operations Fund (DBOF). Preparation of the financial statements is the responsibility of the Defense Finance and Accounting Service (DFAS). The DoD Components and DFAS are jointly responsible for the information in the statements. Our responsibility is to render an opinion on those statements based on our audit.

Disclaimer of Opinion. For FY 1996, as in previous years, we were unable to render an opinion on the financial statements because of the lack of a sound management control structure and significant deficiencies in the DBOF's accounting systems.

DBOF History. Congress created the DBOF on October 1, 1991, by combining the DoD- and Service-owned revolving funds that were previously called the stock and industrial funds. Subsequently, the DFAS, the Defense Information Systems Agency, the Defense Commissary Agency, the Defense Technical Information Center, the U.S. Transportation Command, the Joint Logistics Systems Center, and a Defense Logistics Agency (DLA) function (the Defense Reutilization and Marketing Service) were added to the DBOF.

Changes to DBOF. In December 1996, the Under Secretary of Defense (Comptroller) (USD[C]) announced that the existing DBOF would be eliminated and separate working capital funds would be established. Under the working capital fund concept, the Military Components will be responsible for managing the functional and financial aspects of their support functions and activities and will retain their individuality in managing operations. To clearly reflect each Component's responsibility for the functions within its working capital fund, individual program and financial statements will be presented. There will be no Department-wide budget authorization for a consolidated working capital fund. To accommodate the conversion to working capital funds and to retain the benefits resulting from the actions of the DBOF Corporate Board, the Board will be rechartered as the Working Capital Funds Policy Board. This restructuring does not materially affect the issues raised in this report.

The four Working Capital Funds that have been established are:

- the Army Working Capital Fund,
- the Navy Working Capital Fund,
- the Air Force Working Capital Fund, and
- the Defense-Wide Working Capital Fund.

The new structure of the Working Capital Funds provides a significant advantage over the DBOF structure because separate financial statements will be produced for each Working Capital Fund. Additionally, more Working Capital Funds may be created.

Purpose of DBOF. The DBOF was intended to establish incentives to control resources more efficiently. The DBOF management process was created to:

- foster a businesslike buyer-seller approach that enables customers to make economical buying decisions and encourages sellers to become more cost-conscious;
- identify the full costs of items, measure performance on the basis of cost and output goals, and improve efficiency and productivity;
- consolidate cash control and reduce required cash balances; and
- provide timely and accurate information so that decisionmakers can measure business performance.

DBOF Management Representation Letter. In his Management Representation Letter dated April 9, 1997, the USD(C) candidly acknowledged and summarized significant procedural and systemic deficiencies in the DBOF accounting and financial management systems. These deficiencies included:

- the lack of a fully integrated accounting and reporting system to systematically summarize financial information and provide consistency in financial reporting or comparability of information on DBOF operations;

-
- incomplete incorporation of the U.S. Government Standard General Ledger into DFAS accounting systems;
 - inadequate internal controls over material financial statement accounts, major errors in the valuation and classification of accounts, insufficient reporting and documentation for normal transactions and adjustments, ineffective reconciliations of accounts, and failure to follow accounting procedures; and
 - incomplete compliance with many accounting requirements set forth by the Office of Management and Budget and DoD. Areas of noncompliance included accounting systems; standard general ledger; property, plant, and equipment; inventory valuation; cash reconciliations; and accounting estimates.

Audit Objective

The objective of this audit was to identify and summarize the major accounting and management control deficiencies preventing the timely development and reliable presentation of the DBOF financial statements. See Appendix A for audit scope and methodology and Appendix B for prior audit coverage.

Defense Business Operations Fund Accounting and Management Controls

Despite significant effort and progress, the DBOF's financial statements were unreliable and inaccurate and did not fairly present the financial position of the Fund. This situation was caused primarily by DoD's inability to implement a management control structure that includes all the critical management control elements needed for effective management. Specifically, the DBOF management control structure did not include all the accounting systems needed to effectively compile and report accurate financial information. Longstanding problems with DBOF accounting systems, and their associated financial and logistics feeder systems, were the principal obstacles preventing the compilation of usable financial data. DBOF accounting systems were developed before the DBOF was established and before accounting and finance were consolidated into the DFAS. Generally, accounting and financial data were extracted from accounting systems that were designed without incorporating generally accepted accounting principles and without recognizing the importance of a universally reliable management control structure. In addition, inadequate policies and procedures combined with a generally poor control environment hindered the compilation of meaningful data and the preparation of financial statements. As a result, Congress and DoD managers will continue to encounter the same difficulties in managing the individual working capital funds as they have faced managing the DBOF. We have issued disclaimers of opinion for the past 5 years on the DBOF Consolidated Financial Statements because of the DBOF's poor management control structure.

Management Control Structure

This report summarizes the major systemic accounting and management control deficiencies affecting the collection and presentation of reliable financial data in the DBOF. The deficiencies stemmed from a DBOF-wide management control structure that was inadequate in all of its major components and probably will remain inadequate for some time to come, despite the restructuring of the DBOF. We defined an accounting deficiency as an accounting or control problem that would materially distort or render unusable financial statements or other data needed by management to effectively direct the operations of DBOF. Some specific examples of deficiencies

Defense Business Operations Fund Accounting and Management Controls

include account balances that could not be validated, missing support documentation for transactions and account balances, transactions erroneously recorded or recorded in the wrong accounting period, and accounting systems that are incorrectly programmed or lack the capability to be programmed appropriately.

A management control structure encompasses the organization, methods, and procedures developed by management to help ensure that its objectives are met. The American Institute of Certified Public Accountants "Codification of Statements on Auditing Standards," sections 319.06 through 319.11, January 11, 1994, describes the elements of a management control structure that management should use to achieve its objectives. Specifically, a management control structure consists of accounting systems, control procedures, and the control environment. Each of these elements is closely interrelated with the others and contributes to ensuring adequate control over the integrity and validity of information that an organization produces. The absence or inadequacy of any of these elements makes the overall management control structure ineffective. Appendix C describes these elements in greater detail. Without an adequately functioning management control structure, the chances of management achieving its objectives in an effective and economical manner are diminished. Specific control weaknesses or related issues identified within the outline of the DBOF management control structure in FY 1996 include:

- accounting systems:
 - Interim Migratory Accounting Strategy,
 - cash management,
 - standard general ledger, and
 - documentation and audit trails;
- control procedures;
- control environment:
 - property, plant, and equipment (PP&E),
 - valuation and reporting of inventory, and
 - personnel.

Defense Business Operations Fund Accounting and Management Controls

The recognition of these accounting and management control deficiencies grew out of issues identified during our FY 1996 annual audit of the DBOF financial statements. We identified accounting and management control deficiencies that resulted in auditor-recommended adjustments totaling approximately \$75.1 billion. Figure 1 shows the monetary amount associated with each control element deficiency. Figure 2 shows asset-related deficiencies in relation to total DBOF assets (\$62.5 billion out of \$92.2 billion) and revenue-related deficiencies in relation to total DBOF revenues (\$12.2 billion out of \$73.7 billion). Appendix D shows which organization identified the deficiency, a description of the deficiency, and the amount. Despite the comprehensive nature of our audits, we were not able to identify all potential management-control-related deficiencies.

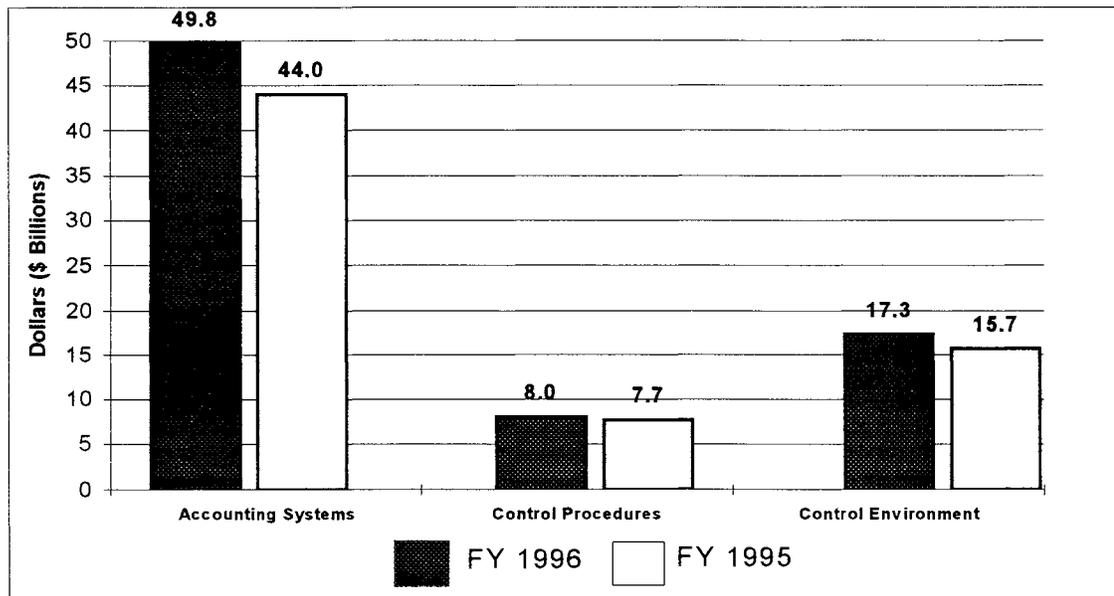


Figure 1. Control Deficiencies by Category for FYs 1995 and 1996

In this report, we have attempted to attach dollar amounts to deficiencies to point out the conspicuous weaknesses noted in broad areas (the areas making up the management control structure) during FY 1996. Only rough numerical comparisons can be made with similar accounts in previous years. Direct comparisons, based on the dollar amounts of the deficiencies, cannot be made with accounts of prior years because auditors change the emphasis of their work from year to year. Thus, conclusions about the improvement or worsening of a specific account should not be attempted. For example, last year we noted approximately \$9.2 billion in weaknesses attributable to intrafund transactions, while indicating none in this year's reports. Nonetheless,

significant problems remain in the area of intrafund transactions, as shown by the inability of the Defense Logistics Agency to separately identify any intrafund transactions.

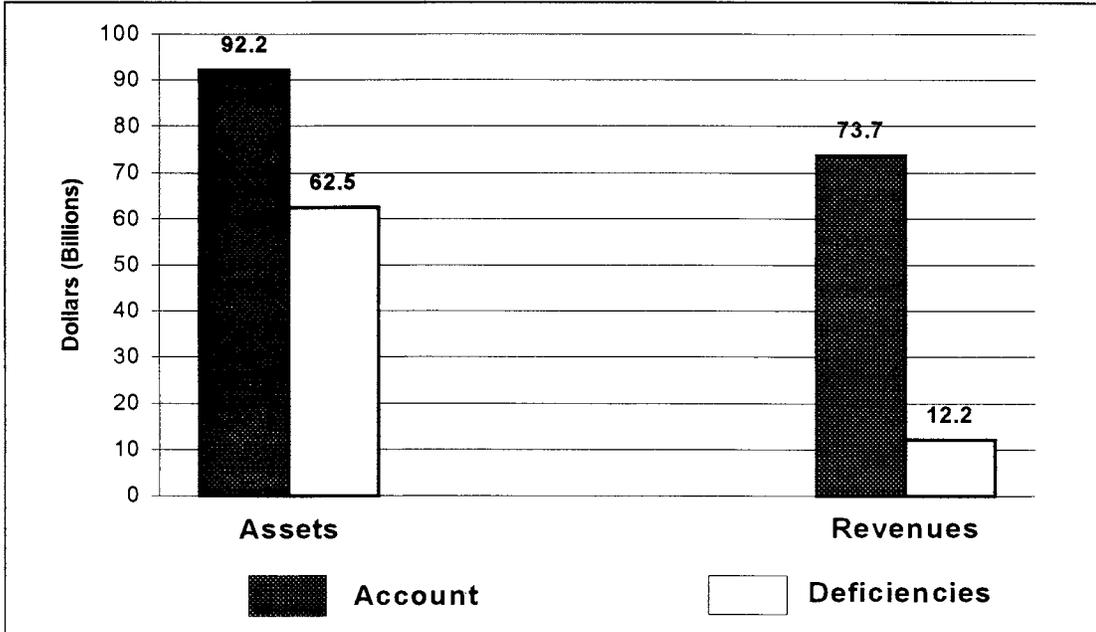


Figure 2. Asset- and Revenue-Related Deficiencies in Relation to Total Assets and Total Revenues

Accounting Systems

Although DFAS has made progress in eliminating a number of legacy accounting systems, the most serious problems in accounting systems will remain unresolved for some time. As noted in many audit reports, significant management control weaknesses continued to exist in many aspects of the DBOF's accounting systems. These weaknesses restricted the effective manipulation of relevant data needed to manage DBOF's operations and hampered the development and use of financial statements. Auditors have identified \$49.8 billion of deficiencies associated with management control weaknesses in DBOF accounting systems. Moreover, because the management control structure is weak and DoD's plans to correct accounting systems does not include all relevant systems, we cannot determine when those accounting systems will be able to produce reliable data and financial statements useful to management. Figure 3 shows the deficiencies associated with accounting systems.

Defense Business Operations Fund Accounting and Management Controls

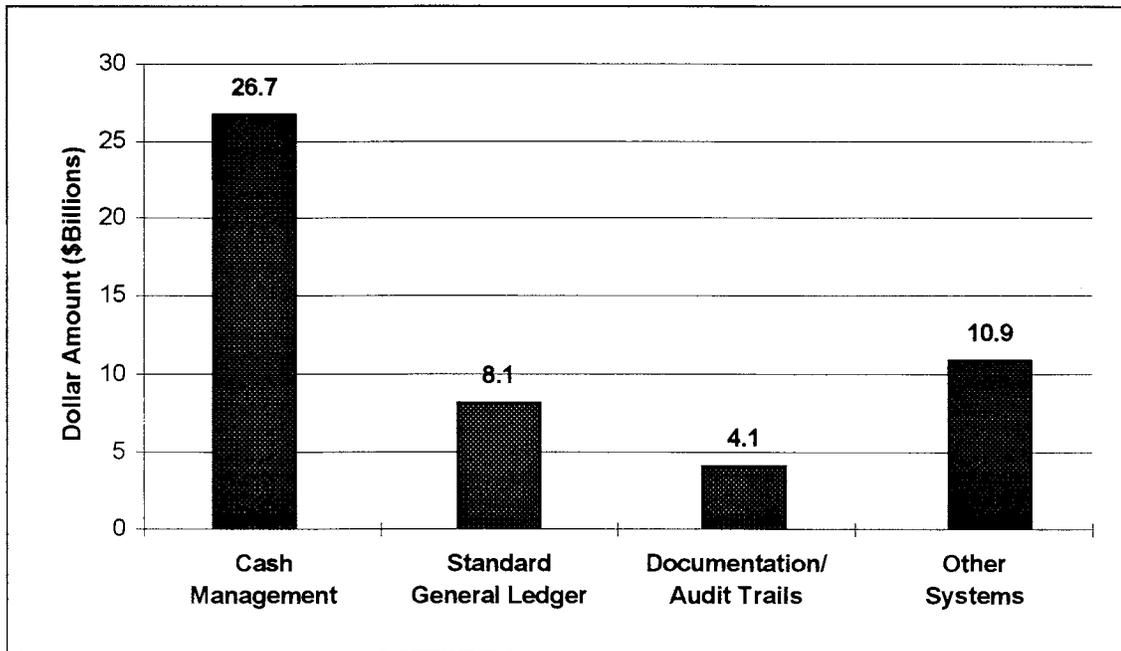


Figure 3. Control Deficiencies in Accounting Systems

DoD senior management has recognized the presence of severe control flaws in the DBOF accounting systems and made a determined effort to modernize its systems and eliminate the weaknesses. In the FY 1996 DBOF Management Representation Letter, April 9, 1997, the USD(C) indicated that he was aware that accounting systems do not provide consistency in reporting or allow for comparison of operational data. He noted that DBOF organizations generally do not have reporting systems that effectively and systematically summarize financial information.

To help repair control weaknesses in the DBOF accounting systems and facilitate the accumulation of standardized data for use in the preparation of financial statements, DoD is implementing a two-phased plan to reduce the number of systems used in DBOF. During the plan's first phase, DoD intends to reduce the more than 80 DBOF accounting systems in use to approximately 17 interim migratory systems. This approach, known as the Interim Migratory Accounting Strategy (IMAS), assigns no more than one interim migratory system to each business area within a DoD Component. The remaining nonselected systems are designated as legacy systems, which will then be incorporated into the existing interim migratory systems. The functional enhancement of the selected interim migratory systems began in 1995. The second phase of the system migration strategy involves the transition from the interim

Defense Business Operations Fund Accounting and Management Controls

systems to an undetermined but smaller number of migratory systems. The DFAS has not established formal completion dates for either phase of its systems upgrade.

The IMAS does not include all relevant accounting systems. Our audits have also identified significant management control weaknesses in the following areas: cash management, standard general ledger, documentation, and audit trails. Management control weaknesses in these areas must be eliminated before reliance can be placed on the DBOF financial statements.

Interim Migratory Accounting Strategy. While DFAS has made progress in reducing the number of DBOF accounting systems, it has not yet put into place a stable strategy for deciding upon and implementing its interim migratory accounting systems. Major modifications to systems development initiatives of this magnitude are not unusual; however, they are costly in both time and resources. The IMAS, implemented in 1994 after an extensive accounting system review process, has been substantially modified from its original plan. Approximately 76 percent of the original accounting systems selected as part of the IMAS have been questioned concerning their feasibility to function as interim migratory accounting systems or have changed their original approach to systems enhancements. Of the original 17 systems selected as interim migratory accounting systems, 3 have been redesignated legacy systems, 5 are being reevaluated for inclusion in the strategy, and 3 others will be forced to change their original approach to system enhancements. As a result of these changes, DFAS cannot develop implementation plans, estimate realistic completion dates, or determine total implementation costs.

Moreover, the strategy used by DFAS did not include all of the systems that support each of the DBOF business areas. The underlying feeder systems were not included in the strategy. In most cases though, the feeder systems were not owned by DFAS. Feeder systems provide the original data to the migratory accounting systems, and include mixed systems. Mixed systems combine accounting and logistics data in the same system. Thus, the interim migratory systems strategy is based on the continued use of many feeder systems. For example, the Air Force's Standard Material Accounting System, an interim migratory system, relied on input from roughly 10 different financial and non-financial feeder systems. For this system, some of the feeder systems were owned by DFAS and others were owned and operated by the Air Force.

Not including the feeder systems in any strategy to improve DBOF accounting systems will result in uncertainty about the credibility of the data emerging from any of DBOF's accounting systems. Also, senior DoD financial managers have expressed

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concerns regarding the quality of the data the interim migratory systems will receive from the feeder systems. In the past, auditors have noted general and application control problems in some feeder systems. Because the quality of the data in the interim migratory accounting systems will only be as good as the data furnished by the feeder systems, they should be included in the strategy to improve DBOF accounting systems. Further, by not including feeder systems in its strategy to improve DBOF accounting systems, DFAS cannot determine completion dates or total costs for its IMAS upgrades. Trustworthy data that is usable by DBOF managers and can be reliably presented in financial statements can be produced only by building a strong management control structure into transaction and review levels of the DBOF accounting systems framework.

Cash Management. The DBOF accounting systems did not possess adequate management controls over cash transactions. Cash management is the process by which managers maintain a sufficient supply of cash to meet day-to-day business needs while maintaining a reasonable allowance for emergencies. It is vital that cash managers maintain an appropriate cash balance to meet their liabilities and to avoid any public law violations that may occur if adequate funds are not available. DBOF managers could not properly monitor and manage cash levels because of severe accounting system problems, insufficient procedures, and incomplete training. A lack of management controls over cash transactions also prevented managers from stopping unauthorized and erroneous cash transactions and from complying with public law to validate cash availability before disbursement. Audits noted \$26.7 billion in problems associated with cash management.

Air Force cash managers experienced serious cash management problems resulting from poor accounting systems. During FY 1996, the Air Force did not record \$13.2 billion in collections and \$13.5 billion in disbursements during the period in which the transactions occurred. This situation occurred because the existing cash accounting systems allow outside entities access to Air Force DBOF cash accounts without the approval of Air Force DBOF managers. For example, for 2 months in early FY 1996, the Army erroneously withdrew approximately \$520 million from the Air Force DBOF account. It may take up to 2 months for Air Force personnel to receive notification of such non-Air Force cash collections and disbursements and enter them in the general ledger system. The cash management systems lacked a real-time capability to report transactions and assess the amount in the fund balance with treasury account. Government agencies other than the Air Force made approximately 47 percent (\$6.3 billion) of all Air Force DBOF disbursement transactions in FY 1996 because they had direct access to the Air Force Treasury account.

Defense Business Operations Fund Accounting and Management Controls

The current cash systems and procedures have caused problems for cash managers in the other services as well as the Air Force. Invalid billing codes at USTRANSCOM have delayed the billing of customers and thus slowed cash flow. Inadequate interfund billing at the DFAS Cleveland Center resulted in an overstatement of cash belonging to the Navy Aviation Depots; cash balances were overstated at the Depots from \$800 million to over \$1 billion. Navy DBOF managers have relied on advance billing customers to remain solvent. If the Navy had not advance billed its customers, its cash balance account would have been negative \$372 million at the end of FY 1995. In FY 1996 the Navy billed \$1.6 billion in advance and has advanced billed \$6.8 billion through May 1997. The Air Force advance billed \$1.8 billion in FY 1997 to maintain a positive cash balance in its Depot Maintenance Business Area.

The problems affecting DBOF cash management were varied and sizable. They included incomplete training for cash managers and Congressional intervention, as well as outmoded accounting systems. Not only were DBOF cash managers hard-pressed to ascertain the amount needed to pay normal debts; they also risked violating the Antideficiency Act because of poor controls over the monitoring of cash. However, cash management systems that would provide managers with real-time information concerning any transactions affecting working capital cash accounts could eliminate many cash management problems.

Standard General Ledger. A major control weakness in DBOF's accounting systems is the lack of a common standard general ledger implemented throughout the DoD. DBOF financial statements will not be fairly presented, and DBOF managers will be unable to manage efficiently until the DoD implements a transaction-driven, integrated accounting system that is based on common standard general ledger accounting. A common standard general ledger implemented throughout the DoD will ensure that all DoD accounting and finance offices use the same accounts as the basis for their financial and management reports.

As shown earlier in Figure 3, auditors have noted at least \$8.1 billion in deficiencies attributable to the lack of a standard general ledger. As an example, the DFAS Denver Center incorrectly included \$4.7 billion of prior-year expenses in the calculation of cost of goods sold on the FY 1996 Air Force Supply Management Business Area statement of Operations. When preparing the FY 1996 financial statements, the DFAS Denver Center erroneously crosswalked \$4.7 billion from Air Force general ledger account code 341.15, Prior Period Adjustments, to DoD Standard General Ledger account code 7291.3, Inventory Losses or Adjustments for the current year. In April 1997, DFAS Denver Center revised the FY 1996 DBOF Air Force Supply Management Statement of Operations by moving the \$4.7 billion from the calculation of Cost of Goods Sold to

Defense Business Operations Fund Accounting and Management Controls

Prior Period Adjustment. The revised statement was included in the FY 1996 DBOF Consolidated Financial Statements. Also, the DFAS Indianapolis Center did not use an integrated general ledger system to produce the Army's FY 1996 financial statements. Instead, the Center relied heavily on budgetary execution reports that field activity commanders certified as accurate.

Even though it is far from being implemented throughout the department, DoD requires the use of its Standard General Ledger for managing data and developing financial reports. The IMAS is designed to incorporate the DoD Standard General Ledger into each migratory accounting system. However, excluding the feeder systems from the IMAS will result in only partial implementation of the DoD Standard General Ledger in all the systems that are relevant to working capital data generation. The data produced at the transaction level must be standardized throughout the DBOF if financial statements are to be valid. Current and prior-year audits have noted that many errors were made when accounting data were produced using nonstandard general ledgers and then crosswalked to the DoD Standard General Ledger. DBOF managers can use financial data for analyzing and comparing only when they believe the data are reliable and comparable. A common standard general ledger for the DoD is a vital management control that cannot be overemphasized and should remain one of the highest priorities for senior financial managers when planning new accounting systems and upgrades to existing systems.

Documentation and Audit Trails. Many DBOF accounting systems lacked satisfactory internal controls over transaction documentation and audit trails. Current accounting and feeder systems were not programmed, or could not be programmed, to retain adequate supporting documentation for accounting transactions. For example, some Air Force accounting systems did not provide adequate audit trails to validate the accuracy of sales and sales return account balances reported on monthly trial balances. Consequently, auditors could not validate the accuracy of \$69.2 million in sales and \$3.6 million in sales returns from December 1995 through February 1996 for 10 bases. Since inadequate audit trails are a systemic problem at many Air Force installations, management could not validate the accuracy of FY 1996 base-level sales of \$2.7 billion and sales returns of \$122.7 million.

Insufficient documentation slows the accounting process and can result in unsupported or inaccurate accounting transactions, with adverse consequences for the preparation and use of data in financial statements and by management. Poor documentation also negatively affects the fairness of the presentation of account balances. Moreover, the scarcity of documentation has forced auditors to limit their work. Since auditors trace accounting transactions to the original entries on source documents, often following

Defense Business Operations Fund Accounting and Management Controls

audit trails through feeder accounting systems, it is crucial that the DFAS IMAS include feeder systems in its accounting system upgrades. Incomplete or no audit trails, if uncorrected, will continue to hinder the efforts of auditors to reach a conclusion about the fair presentation of data on DBOF financial statements.

In addition to poor accounting systems, other reasons for the widespread documentation problems included nonexistent or incomplete guidance and inadequate management oversight. These control weaknesses were evident at all accounting transaction levels. Other significant documentation and audit trail problems caused by weaknesses in accounting systems included the following:

- The DFAS Denver Center made 111 adjusting entries, valued at \$217.5 billion, lacking sufficient supporting documentation. (Note: This amount was not included in the total amount of deficiencies.)

- \$555.2 million of equipment-in-use items (a DBOF property, plant, and equipment account) could not be verified because they had been purchased and placed in operation since the inception of DBOF without retaining adequate supporting documentation.

Control weaknesses in documentation are compounded because correcting accounting records and preparing financial statements depends heavily on manual adjustments. The accuracy of data in DBOF's financial statements will remain questionable as long as significant documentation problems continue. Thus, management control weaknesses in documentation and audit trails must be addressed in the feeder systems as well as in the interim migratory accounting systems.

Management Control Procedures

Management control procedures are the policies and procedures used by management, in addition to accounting systems and the control environment, to achieve the organization's goals and objectives. FY 1996 audit reports noted serious weaknesses in management control procedures, including inadequate guidance, that contributed to the dissemination of erroneous financial data and the preparation of unreliable financial statements. Moreover, inadequate management control procedures will hinder the implementation of the IMAS if policies and procedures are not improved at all levels of accounting systems, including the accounting and logistics feeder systems.

Defense Business Operations Fund Accounting and Management Controls

Guidance. Many accounting problems affecting DoD financial data and, consequently, DBOF financial statements, could be directly attributed to deficient management control procedures. Deficiencies totaling \$8.0 billion were attributed to nonexistent guidance or noncompliance with existing guidance, as shown in Figure 4. FY 1995 deficiencies caused by guidance problems totaled \$7.7 billion. Appropriate guidance at all accounting levels is essential for building and maintaining a sound management control structure. Audits regularly showed that comprehensive and timely guidance is fundamental for the compilation of data that is relevant to management and that can be accurately presented in financial statements. Nevertheless, weaknesses in control procedures were widespread among all Military Departments and Defense agencies and represented a large number of the deficiencies noted by DoD auditors. Weaknesses in the management control structure caused by poor policies and procedures occurred because DBOF accounting guidance was not always properly followed, up-to-date, or even developed in some cases. Figure 4 divides the control procedure problem into two specific areas where most guidance weaknesses were found, noncompliance with existing guidance and guidance that did not exist.

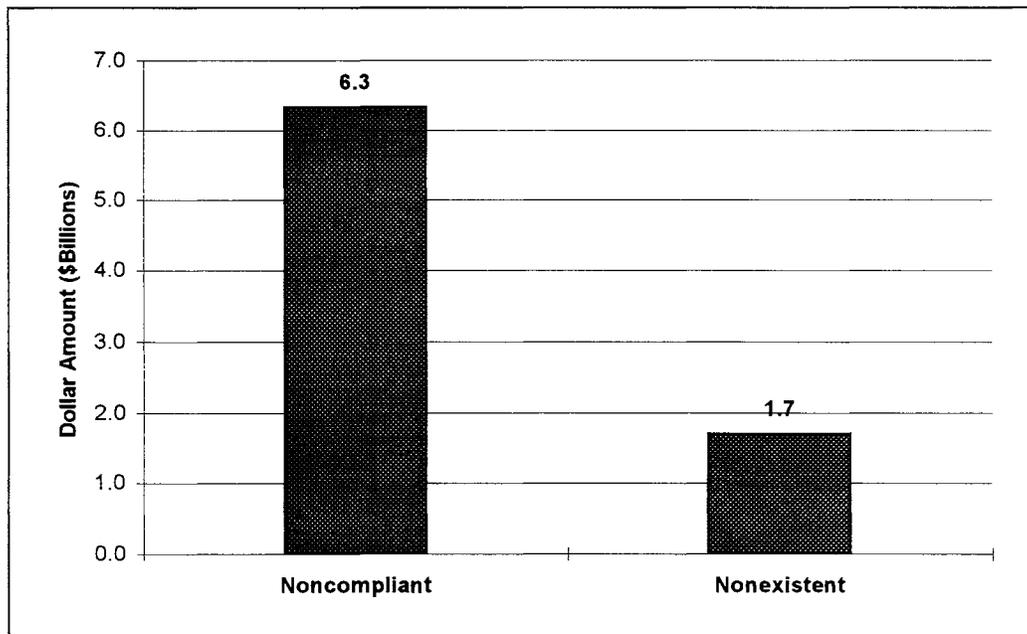


Figure 4. Deficiencies in Control Procedures

DoD has attempted to bolster DBOF policies and procedures by issuing the 7000.14-R, "DoD Financial Management Regulation," volume 11B, "Reimbursable Operations Policy and Procedures—Defense Business Operations Fund," December 1994. However, audits and followup reviews revealed that weaknesses in guidance continued.

Defense Business Operations Fund Accounting and Management Controls

For example, DoD accounting policy did not provide guidance for accurately valuing inventory for DBOF organizations. As a result, some subaccounts included in the inventory allowance account did not represent changes between the historical cost and the standard price of items. Instead, the accounts contained gains and losses that are part of business operations during the year and should be recognized when they are incurred to ensure that inventory and operating results are correctly stated. By including all of the subaccounts required in the DoD 7000.14-R, volume 11B, the amounts shown on the Army's FY 95 financial statements overstated the Inventory, Net, line and understated the loss shown as operating results by about \$1.7 billion.

Also, because of their interpretation of DoD 7000.14-R, volume 11B, DFAS personnel did not record as a financing source (invested capital used) depreciation for donated assets valued at over \$1.3 billion. If not corrected, Air Force Depot Maintenance Business Area personnel will include excessive depreciation expenses totaling \$519 million for donated assets in future customer sales rates. Further, the Air Force Depot Maintenance Business Area recovered \$210 million more than required to fund the FYs 1993 through 1997 capital budget total of \$269 million. In addition, because the Navy did not follow DoD guidance concerning the elimination of aged liabilities from official accounting records, those records did not include about \$81.4 million of Accounts Payable, Federal, as of June 30, 1996.

Implementation. Deficiencies in management control procedures occurred principally because policies and procedures were not followed, not understood, insufficient, or not developed. The fluctuating DoD environment and the breadth of its financial problems have impeded attempts by financial managers to draft and disseminate timely and pertinent guidance. This has directly contributed to the inability of DoD accountants to produce fairly presented financial statements for DBOF. Substantial improvement in drafting, distributing, and implementing of management control procedures is crucial to the success of the IMAS. Equally important is the dissemination of current and relevant guidance to accountants working with the DBOF feeder systems. Otherwise, accounting field offices will have new or upgraded systems with which to work but will lack the policies and procedures needed to understand and operate these newly enhanced systems. Improving management control procedures is vitally important to, and must coincide with, DoD financial system modernization programs.

Management Control Environment

Severe deficiencies in the DBOF control environment have added to the difficulty of generating dependable financial data and usable financial statements. The control environment represents the organizational influences that establish or enhance specific policies and procedures. It reflects the overall attitude, awareness, and actions of managers and others concerning the importance of control and its emphasis in the organization. Defects in the control environment have also weakened the overall management control structure and have diminished the ability of the DBOF to precisely identify and report costs and to use identified costs to manage operations.

Auditors assessed control environment weaknesses by noting deficiencies in the material areas of PP&E and inventory, resulting in \$17.3 billion in auditor-recommended adjustments. The deficiencies materially affected financial statement preparation because the accounts are very large in relation to total assets. Many of these problems were caused by inadequate accounting systems but are discussed separately from accounting systems because of their materiality. The PP&E and inventory accounts constituted approximately 83.1 percent of the total DBOF assets. These deficiencies reveal the inability of DoD management to correct the considerable control weaknesses in these large accounts. Auditors also identified additional weaknesses in the personnel area. The success of the IMAS is especially linked to improvements in the control environment.

Property, Plant, and Equipment. An ineffective control environment allowed inadequate accounting to continue for many items of PP&E. PP&E constituted approximately 13.3 percent of total DBOF assets. Because of their high level of materiality on the financial statements, excluded or improperly valued PP&E assets greatly distorted the financial statements. This distortion occurred because assets were improperly capitalized, incorrectly recorded, or lacked cost documentation. In some cases, asset depreciation was inaccurately calculated because the useful life of assets was incorrectly estimated. Inexact application of depreciation procedures also contributed to errors in depreciation accounts. In other instances, fixed assets had been received or removed without accounting recognition. For example, DBOF accountants could not effectively account for and auditors could not verify the accuracy of \$829.8 million of equipment items in DBOF financial reports. The \$829.8 million in equipment that could not be accounted for consisted of \$274.6 million in assets that managers could not locate because it had been previously disposed of or transferred to other organizations. The remaining \$555.2 million of equipment could not be verified

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because the equipment items had apparently been purchased and placed in service after the inception of DBOF but lacked adequate supporting documentation.

Noncompliance with existing procedures contributed to many problems with fixed assets and asset depreciation. Additionally, the lack of documentation for older assets causes problems in accounting for PP&E assets. Deficiencies affecting PP&E totaled approximately \$2.0 billion, as shown in Figure 5. The total amount of adjustments associated with PP&E accounting problems was not available because DoD could not determine overall fixed asset balances or assign proper values to PP&E. Consequently, the amount noted in the table is significantly understated. Auditors were not able to obtain such basic information as the universe of items comprising DBOF PP&E. This lack of universe data limited the scope of the audit and prevented auditors from forming an opinion regarding the accuracy of any PP&E value shown on the DBOF consolidated financial statements.

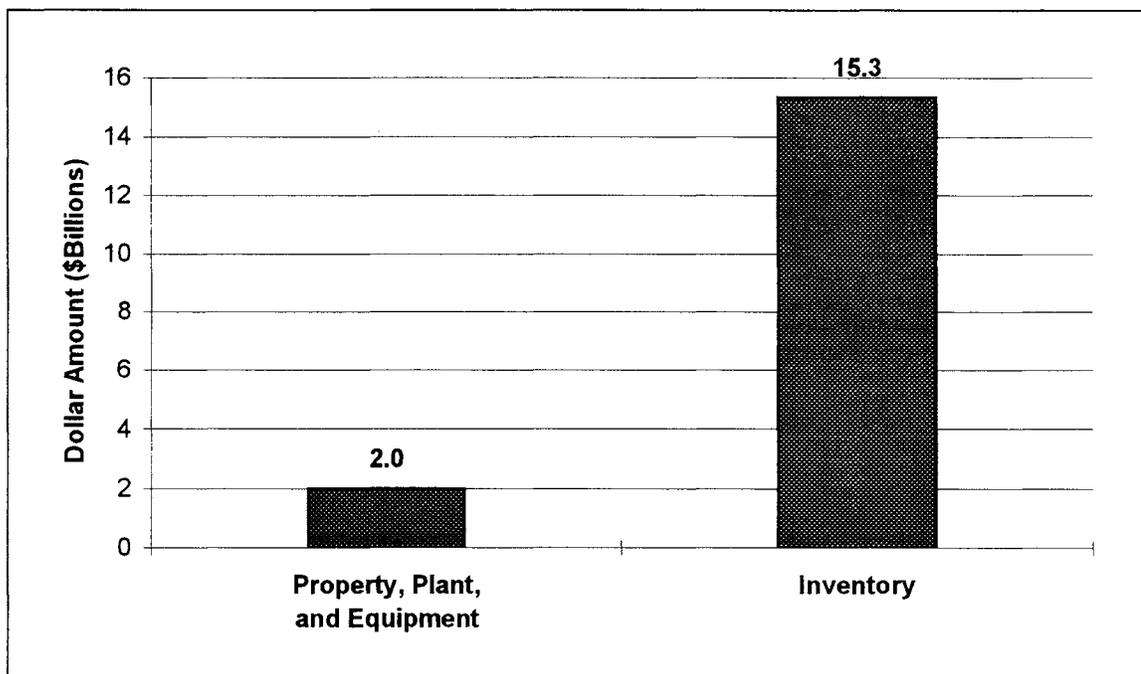


Figure 5. Deficiencies in the Control Environment

DoD has responded to property accountability weaknesses by electing to migrate to a DoD-wide standard property accountability system, called the Defense Property Accountability System. This system was developed to maintain property accountability and depreciation accounts and to schedule preventive maintenance and monitor equipment utilization. Originally scheduled for implementation throughout DoD by

1997, the estimated completion date for fielding the system is now late 2000. The slippage in implementation occurred because when the system was selected, it was designed to interface with single, standard systems in tangential business areas (that is, accounting, procurement, supply). However, since DoD has chosen multiple systems in these areas, many additional interfaces need to be built, resulting in incremental systems deployment.

Although not a DBOF interim migratory system, the successful implementation of the Defense Property Accountability System will have a major influence on the ability of DBOF to produce accurate and useful financial statements. This system is but one example of the many systems that will feed data to DBOF systems and upon which DBOF managers will rely for cost information. Thus, significant control environment weaknesses indicated the need for management's constant attention to the PP&E account.

Valuation and Reporting of Inventory. Significant weaknesses continue to affect inventory accounts in several DBOF business areas. Because inventory accounts represent approximately 69.8 percent of the DBOF's total assets, identifying and correcting material weaknesses in inventory accounts and processes is extremely important. The approximately \$15.3 billion of deficiencies associated with inventory accounts and processes (Figure 5) were caused by incorrect physical inventory counts, errors in transaction processing and recordkeeping, retention and incorrect reporting of excess inventories, faulty inventory guidance, incorrect implementation of guidance, and improper inventory revaluation. Moreover, valuation and reporting problems in the DoD inventory accounts contributed to inaccurate financial statements. More important, DBOF managers were unable to depend on inventory data when making management and financial decisions.

Examples of the extensive inventory problems throughout the DBOF are as follows:

- The DFAS Indianapolis Center inadvertently decreased Inventory, Net, twice for the estimated cost of depot-level repairables. As a result, the end of FY 95 Inventory, Net, was understated by about \$1.2 billion. During FY 1996, DFAS Indianapolis Center personnel made an accounting adjustment that only partially corrected the error, because Accumulative Operating Results still needed to be reduced by \$1.2 billion. These errors occurred mainly because Center personnel lacked experience with the various accounts involved.

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- For material returns that were included on the Army's FY 1996 financial statements, auditors questioned the validity of \$1.3 billion in asset account balances and \$362 million in liability account balances.
- Air Force accounting and logistics systems did not have adequate edit controls to correctly record purchases and account for nonpurchase receipt transactions in the Supply Management Business Area general ledger accounts. Information extracted from depot logistics systems did not contain sufficient contract information to correctly classify purchase transactions. Consequently, the depot accounting system accepted nonpurchase receipt transactions that overstated the Purchases at Standard account by \$763.6 million. The accounting system also misclassified receipts from repair transactions, overstating the Inventory at repair Contractors account by \$711 million. Further, auditors could not validate \$9.6 billion in FY 1996 purchase at standard price transactions because of similar systems weaknesses.
- Additionally, a statistical sample of 2,878 secondary inventory items, consisting of spare and repair parts, indicated that the inventory amount reported in the DBOF financial statements was misstated by \$3.9 billion. This occurred because the storage activities' inventory records were not reconciled with the inventory records maintained by the DLA inventory control points. Inaccurate inventory records also occurred as a result of errors in processing inventory transactions.

Because of the high proportion of inventory to overall DBOF assets, sustained material control environment weaknesses relating to inventory will continue to affect the fair presentation of DBOF financial statements. Inventory problems will also make the goals of accurate cost recognition and cost planning more difficult to achieve. Moreover, the inventory deficiencies noted in this section are directly related to weaknesses in the other areas of the management control structure, particularly accounting systems. Weaknesses in inventory accounting systems and related feeder systems must be fixed to produce inventory data that management can use to properly control inventory levels in the DoD.

Personnel. We have noted critical weaknesses in the important area of personnel. Problems in this area are similar to those we have reported on in previous years. We mention them again to remind management of the pervasiveness of these problems, as noted in this year's audit reports. Deficiencies included incomplete or no training, ineffective communications between various management levels, excessive manual transactions, insufficient management oversight, and an inability of management to respond to a rapidly changing accounting environment. For example, some audit

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reports have documented a widespread failure of accounting personnel to understand basic accounting theories and principles that support transaction entries.

Further, development and use of financial statements has been adversely affected by the loss of experienced personnel because of downsizing and retirement. This loss of experience, or "corporate memory," is a major problem because operating procedures and instructions have not been documented. Trained and experienced personnel are essential for the successful implementation of a complex plan such as the IMAS. Improvements in the DBOF management control structure will not occur without greater management attention to personnel weaknesses. Since weaknesses such as insufficient training have a direct and adverse impact on the introduction and use of new accounting systems, corrective actions must be directed at all relevant levels of accounting transactions. This includes directing corrective actions at the control environment surrounding the DBOF feeder systems as well as at the control environment encompassing the interim migratory accounting systems.

Noted Improvements. Although many of the accounting systems problems discussed in the audit reports of previous years remain unresolved, some aspects of the DBOF management control structure have shown improvement. Auditors have noted improvement in the following areas:

- Of 34 recommendations made to the Army and DFAS by the Army Audit Agency, 26 have been closed. Actions taken on 24 of the 26 recommendations were effective. Some organizations took aggressive action to implement solutions. For example, in response to the Army Audit Agency's recommendation concerning real property issues, the Assistant Secretary of the Army (Financial Management and Comptroller) formed the Real Property Integrated Process Team to develop a comprehensive solution to problems in accounting for real property.
- The USD(C) incorporated new guidance concerning the proper reporting of PP&E into DoD 7000.14-R, volume 11B.
- Some DBOF organizations have initiated wall-to-wall inventories of their assets and are recording these assets in financial reporting records.

To resolve some of the longstanding problems associated with the DBOF, Congress instructed the Secretary of Defense in the FY 1997 Defense Authorization Act to submit a DBOF Improvement Plan. In response, the USD(C) directed that a study be conducted outlining a plan to improve the management and performance of the Defense

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Working Capital Funds, DBOF's successor. The resulting study, known as the Defense Working Capital Funds Study, involves representatives of DoD's financial and logistics communities and also includes DoD's working capital fund customers. This diverse mix of working capital fund employees and customers has created a forum for free and candid discussion about the problems confronting all DoD working capital funds. Some of the issues addressed by the study group include:

- identifying ways of reducing costs in the working capital funds;
- developing a basic, but adaptable, cash management model for all areas to use;
- determining better methods for revenue recognition;
- determining the cost components of stabilized rates;
- establishing a demolition program for unneeded plant capacity; and
- developing policies to support increased interservicing and sales across Military Departments.

We believe this forum is an excellent method of addressing working capital fund issues and should be convened periodically to allow for continued discussion about DoD working capital funds, continuous process improvement, and followup on agreed-upon actions.

Summary

This report on the accounting and management control deficiencies in the DBOF is the result of our review of DBOF-related audits conducted during FY 1996. We identified several major categories of accounting and management control weaknesses totaling approximately \$75.1 billion. Although weaknesses thoroughly pervaded the three elements of the management control structure, deficiencies were found mainly in the DBOF's accounting systems. Deficiencies in accounting systems totaled \$49.8 billion; in management control procedures, \$8.0 billion; and in the management control environment, \$17.3 billion. These deficiencies prevented the accurate compilation of accounting data and the development and presentation of accurate, reliable, and timely

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financial statements. DoD financial managers have acknowledged the seriousness of the weaknesses within the DBOF management control structure and have developed the two-phased IMAS as part of their plan to strengthen the overall accounting structure. However, the IMAS is not yet complete and does not have an established schedule or an estimated total cost. The IMAS does not include all of the relevant systems that pass accounting data to DBOF managers and financial statements.

In this report, we concentrated on identifying specific accounting and management control deficiencies to help management focus its limited resources where corrections may result in the highest immediate rewards. Management should:

- incorporate all relevant accounting, finance, and logistics migratory and feeder systems into the DBOF IMAS;
- implement adequate monitoring controls over cash management to record cash transactions in the proper accounting period and prevent unauthorized and erroneous cash transactions;
- ensure implementation of the U.S. Government Standard General Ledger in all relevant DBOF systems; and
- develop and publish accounting guidance that covers all pertinent aspects of the DBOF accounting process, ensure distribution to all users, and follow up to ensure consistent implementation.

We believe that by focusing on the three main components of the management control structure, management can address many of the problems identified in this report. However, because the problems in DBOF's management control structure were so pervasive, we cannot report an estimate of the costs required to correct the weaknesses. These deep-rooted defects also preclude an informed estimate of the time needed to fix the problems associated with DBOF, now the Defense Working Capital Funds. Thus we cannot determine when viable financial statements will be produced that will fairly present the financial status of the reorganized DBOF. We plan to report annually on accounting and management control deficiencies that significantly hinder the compilation of accurate accounting data and prevent the production of useful and reliable financial statements for the Defense Working Capital Funds.

Recommendations, Management Comments, and Audit Response

We recommend that the Under Secretary of Defense (Comptroller) conduct periodic reviews of all issues affecting the Defense Working Capital Funds, with participants drawn from all Military Departments and Defense Agencies. The reviews should be similar to the FY 1997 Defense Working Capital Funds Study initiated by the Under Secretary of Defense (Comptroller) in response to the FY 1997 Defense Authorization Act.

Management Comments. The Deputy Chief Financial Officer partially concurred with our recommendation, stating that although accounting and management control deficiencies should be reviewed by his office and the Defense Finance and Accounting Service, he believed that the recommendation to conduct reviews similar to the FY 1997 Defense Working Capital Fund Study would result in reviews that are too formal and structured. He further stated that such formal and structured reviews would not be necessary, or effective, and could require the expenditure of resources out of proportion to the expected benefits. The Deputy Chief Financial Officer indicated that quarterly budget reviews and other meetings with representatives of the Military Departments and the Defense agencies are adequate to discuss accounting issues and propose solutions.

Audit Response. The Under Secretary of Defense (Comptroller) comments are partially responsive. Based on management's comments, we made corrections to the report where appropriate. We continue to believe that a periodic and structured approach specifically dedicated to addressing accounting and management control deficiencies associated with Working Capital Funds is an excellent method to help correct systemic weaknesses. A structured and independent approach, similar to the one employed in the FY 1997 Defense Working Capital Funds Study, is more conducive to addressing systemic accounting and management control deficiencies than an approach in which discussion of such weaknesses is ancillary to other business.

A structured approach to continuous process improvement in the working capital fund area offers the most potential for success. The participants could concentrate wholly on fixing perceived weaknesses, without being distracted by other concerns. Managers from the Military Services and Defense agencies would take such a structured approach more seriously. The candor and enthusiasm of the participants in the FY 1997 Defense Working Fund Study was especially noted by the Office of the Inspector General, DoD, auditors who participated and we attribute that atmosphere to the considerable credibility lent to the process by the formal approach and the overt sponsorship of the

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Congress and senior DoD management. We are concerned that reliance on less focused mechanisms to surface working capital fund issues will be much less effective and is likely to lose the momentum being generated by the current effort.

We request that the Under Secretary of Defense (Comptroller) reconsider its position regarding our recommendation to conduct periodic reviews of all issues affecting the Defense Working Capital Funds and provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope

Audit Work Performed. We reviewed FYs 1995 and 1996 financial statement and financial performance audit reports on DBOF from the IG, DoD; the Army Audit Agency; the Naval Audit Service; and the Air Force Audit Agency. We also reviewed General Accounting Office audit reports regarding the DBOF. Appendix B lists some of the reports reviewed. The amounts noted for each deficiency were taken only from FY 1996 audit reports. This portion of the DBOF audit was limited to identifying and summarizing the major accounting and management control deficiencies that prevented accurate development and reliable presentation of the DBOF financial statements. We defined a major deficiency as a problem that would materially distort or render unusable the DBOF financial statements. A deficiency, as defined in this report, could consist of a large number of separate accounting errors at the transaction level. We also contacted DoD officials responsible for ensuring that corrective actions were taken or under way.

Limitations to Audit Scope. Issues pertaining to management controls in this report were taken from the audit reports we reviewed. The scope of the audit was limited because we did not independently review the management control programs of any of the organizations discussed in this report. This report summarizes the most significant accounting and management control deficiencies noted in audit reports by the IG, DoD, and the Military Department audit organizations.

Methodology

Audit Type, Dates, and Standards. We performed this financial-related audit from March 1997 through June 1997. We conducted our audit in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD. We did not use computer-processed data to conduct this audit.

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

Appendix B. Summary of Prior Coverage

Consolidated DBOF Reports

IG, DoD, Report No. 97-006, "Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund in FY 1995," October 15, 1996. We reported that the DFAS continues to prepare financial statements that do not fairly present the financial position of the DBOF. The financial statements are unreliable, inconsistent, and inaccurate. This situation was caused by management's inability to implement a control structure that enabled DBOF accounting systems to effectively compile and report accurate financial information. Control weaknesses were categorized as follows:

- accounting systems (supporting suites, standard general ledger, documentation, audit trails, and intrafund transactions),
- control procedures (guidance), and
- control environment (PP&E, inventory evaluation, personnel, and previously noted control weaknesses).

As a result, Congress and DoD managers were not been able to effectively use DBOF financial statements and underlying systems for management oversight. Inadequate management controls, if not corrected, could adversely affect the implementation of the DBOF migratory systems. No recommendations were made in this report; therefore, management comments were not required, and none were received.

IG, DoD, Report No. 96-178, "Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1995," June 26, 1996. We were unable to render an opinion on the FY 1995 DBOF Consolidated Financial Statements. The disclaimer of opinion was attributed to deficiencies in the internal control structure of the financial systems and noncompliance with laws and regulations. As a result, the financial position of the Defense Business Operation Fund could not be determined or presented in a fair and timely fashion.

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The lack of standard general ledger accounts and basic accounting knowledge caused expenses, revenues, accounts receivable, liabilities, and accounts payable to either be misstated or understated. Assets were incorrectly reported and recorded with incorrect charges to depreciation. Both the misstatement of revenue and cash disbursements not being validated prior to payments were caused by the lack of sound accounting procedures. Accounts could not be validated because of the absence of supporting documentation. Failure to comply with Title 31, United States Code, and noncompliance in accounting systems; accounting estimates; cash recalculations; inventory valuation; facilities, equipment, and software; and revenue recognition materially affected the fair presentation of the financial statements for the Defense Business Operations Fund. No recommendations were made in this report; therefore, management comments were not required, and none were received.

IG, DoD, Report No. 95-294, "Major Accounting Deficiencies in the Defense Business Operations Fund in FY 1994," August 18, 1995. We reported that the DBOF was not able to prepare financial statements that fairly present the DBOF financial position since its establishment in 1991. The financial statements prepared were untimely, unreliable, inconsistent, and inaccurate. As a result, Congress and DoD managers could not effectively use the DBOF financial statements and underlying systems for management oversight. Additionally, the unauditable financial systems reflected the inadequate internal control structure within DBOF, which negatively affected day-to-day operations. Major deficiencies identified during the audit were grouped into accounting system characteristics and overall management issues. The DBOF accounting and financial systems compiled information inefficiently. A major obstacle to the development and use of reliable financial statements was the lack of a universally implemented standard general ledger. The DoD Standard General Ledger was partially implemented in a few DoD accounting systems; other systems used crosswalks in an attempt to recategorize data. Insufficient documentation and poor audit trails characterized many DBOF accounting and financial systems. Additionally, inadequate accounting for intrafund transactions contributed to significant distortions on the financial statements. The report stated that several DFAS centers either did not have in place, or did not fully use, automated reasonableness and edit checks. Failure to use such checks resulted in incorrect financial statements, and excessive time and effort was spent in correcting avoidable accounting problems. Furthermore, footnote disclosures to the financial statements issued by the DFAS centers did not provide accurate overviews and supplemental information.

Deficiencies existed in the overall management of the DBOF accounting and finance systems. Many accounting problems at DoD organizations and on DBOF financial statements were attributed to deficient DBOF guidance. The guidance was not always properly distributed or understood, was not up to date, or was not been developed in some cases. Additionally, inadequate accounting for many items of PP&E materially distorted the preparation and presentation of the FY 1994 DBOF financial statements. Also, because of inaccurate valuation in DoD inventory accounts and misclassification in other line item accounts, preparation of financial statements was flawed, and financial statements were not usable. Finally, development and use of the financial statements was adversely affected by problems with accounting personnel, such as inadequate training, shortages of support personnel, poor communication between field offices and headquarters, loss of corporate knowledge, and a lack of documented procedures. No recommendations were made in this report; therefore, management comments were not required. The Under Secretary of Defense (Comptroller) concurred with the report.

IG, DoD, Report No. 95-267, "Defense Business Operations Fund Consolidated Statement of Financial Position for FY 1994," June 30, 1995.

We were unable to render an opinion on the FY 1994 DBOF Consolidated Statement of Financial Position because of the lack of a sound internal control structure; noncompliance with regulations; and deficiencies in the accounting systems, all of which prevented the preparation of accurate financial statements. Material internal control weaknesses were found in each of the accounts reviewed. The Air Force Inventory In-Transit account for business organizations had a negative balance. A negative balance in an inventory account indicated an internal control problem in the accounting system that produced those figures; therefore, the system cannot be relied on. Several conditions were noted in accounts receivable for the Defense Logistics Agency Distribution Depot and Air Force Depot Management business areas. For example, misstatements occurred because transactions were unsupported and unverified; the incorrect recording of accounts receivable caused overstatements in the account; weak internal controls caused reimbursements to be collected but not posted or recorded; and funding documents were not received, which prevented the organizations from billing customers. The DLA PP&E account was materially understated. The Navy PP&E account was overstated because assets could not be located; costs were unsupported; and assets were incorrectly recorded. The IG, DoD; the Naval Audit Service; and the Air Force Audit Agency found reportable conditions in accounts payable that affected the reliability of the balances. The conditions included accounting errors, negative

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balances, and accounts payable disbursements that were not posted to the accounts payable balance; accounts payable disbursements that were not recorded; and a lack of supporting documentation. The Army's Other Intragovernmental Liabilities account contained invalid transactions, but adjustments were made to the financial statements before the yearend account balances were submitted to DFAS Indianapolis Center. The Navy's Other Liabilities account was overstated because of system-wide processing problems. The Navy did not include the required Intrafund Elimination note to the financial statements because the Navy did not have the procedures needed to collect data for the note to the financial statements.

We reported several instances of noncompliance with laws and regulations. DoD did not comply with the Federal Financial Management Act of 1994, which established a deadline of March 31, 1995, to provide unaudited FY 1994 financial statements to OMB. This delay was caused in part by the Navy. The report stated that the systems for accounting and internal controls did not completely or accurately disclose the financial position of the DBOF organizations as required by Title 31, United States Code. The FY 1994 DFAS Annual Statement of Assurance reported that the majority of the financial management systems did not meet the requirements of OMB Circular No. A-127. One of the systems used by Army Supply Management was not using standard general ledger accounts, as required by DoD 7220.9-M. Most Army depot maintenance organizations did not have an accounting system that allows them to compute depreciation on separate buildings, as required by DoD 7000.14-R. The Army did not comply with Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," October 27, 1993, which states that inventory should be revalued to its latest acquisition cost at year's end. The Navy and two Defense Accounting Offices used estimated figures, contrary to DoD 7220.9-M guidance, which prohibits estimates in the Statement of Accountability. No recommendations were made in this report; therefore, management comments were not required. The USD(C) generally concurred with the report. The Navy objected to our statement that the audit was impeded in part because Navy management made repeated adjustments to the Navy DBOF financial statements. We responded that the Navy's comments failed to consider the requirement in the Federal Financial Management Act of 1994 to submit the FY 1994 DBOF financial statements to OMB by March 31, 1995.

IG, DoD, Report No. 94-161, "Consolidated Statement of Financial Position of the Defense Business Operations Fund for FY 1993," June 30, 1994. We were unable to render an opinion on the FY 1993 DBOF Consolidated Statement of Financial Position because of significant internal control deficiencies and noncompliance with regulations. We reported numerous internal control problems associated with four accounts of the DBOF financial statements. The principal problems in the Fund Balance With Treasury account were the definition of the account and the reconciliation of balances. The DoD definition of this account was not consistent with accounting principles, which made the balance misleading. Additionally, the individual organizations could not reconcile their own portions of the account because the information was integrated with other DoD Fund Balance With Treasury information. Misstatements were reported for the Defense Logistics Agency and the Navy for this account. The Inventory Held for Sale, Net, account and the Inventory Not Held for Sale account had valuation and classification problems and material discrepancies. Specifically, for the Inventory Not Held for Sale account, negative inventory balances were reported, and the accuracy of War Reserve assets could not be verified. The Army and the Air Force did not maintain appropriate source documentation for items included in the PP&E account, which made those portions of the account unauditible. Also, the Air Force did not report all PP&E items in the DBOF financial statements. Additionally, the PP&E account for the Joint Logistics Systems Center was misstated because that organization did not implement an effective internal control program.

We reported numerous instances of noncompliance with regulations. The DFAS Indianapolis Center did not use an integrated general ledger to produce the FY 1993 financial statements, as required by OMB guidance, and several Army DBOF supply systems did not use the standard general ledger system required by DoD 7220.9-M. We also reported that the Defense Logistics Agency did not effectively implement an internal management control program for reporting the results of physical inventories. Also, the Army valued all inventories at standard price, but the Defense Logistics Agency valued only reutilization and marketing inventories at standard price. Neither of those valuation policies adheres to the Statement of Federal Financial Accounting Standards Number 1, "Accounting for Selected Assets and Liabilities," March 30, 1993. We also reported that most Army Depot Maintenance organizations did not have accounting systems that allowed them to compute depreciation for separate buildings, as required by DoD 7220.9-M. Finally, the Notes to the FY 1993 DBOF Financial Statements did not comply with "DoD Guidance on Form and Content on Financial Statements for FY 1993 and

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FY 1994 Financial Activity." The financial statements included only 4 notes, not the required 26. No recommendations were made in this report; therefore, management comments were not required, and none were received.

IG, DoD, Report No. 93-134, "Principal and Combining Financial Statements of the Defense Business Operations Fund - FY 1992," June 30, 1993. We were unable to render an opinion on the FY 1992 DBOF Financial Statements because audit trails were inadequate, accounting systems were inadequate, significant internal control deficiencies existed, significant instances of noncompliance with regulations were found, and legal and management representation letters were not received. We reported numerous material internal control weaknesses that affected the reliability of the FY 1992 financial statements. Transactions were not properly recorded and accounted for because controls over cash were inadequate, transactions by and for others were not recorded in a timely manner, intrafund transactions were not eliminated or reported, and certain accounts were not properly accounted for. We could not ensure that assets were safeguarded from unauthorized use because supporting documentation was lacking and because the capital asset and inventory accounts were not correctly valued and we could not determine whether these accounts existed. Transactions were not executed in compliance with existing guidance. Reconciliations, uniform accounting systems, and a standard general ledger were lacking, and the weekly flash cash reports were unreliable.

Several instances of noncompliance with laws and regulations materially affected the reliability of the FY 1992 financial statements. The DBOF accounting systems did not meet the requirements of the Budget and Accounting Procedures Act of 1950 and the GAO "Policy and Procedures Manual for Guidance of Federal Agencies," Title 2, "Accounting." The USD(C) was not in full compliance with OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements," which implemented the Chief Financial Officers Act. In addition, quarterly and annual reports to the Department of the Treasury on Accounts and Loans Receivable Due From the Public were not accurately prepared. Air Force Supply Management did not follow requirements of DoD 7220.9-M. Real properties were improperly reflected as assets on the DBOF financial statements and did not comply with the requirements for Real Property Ownership under Title 10, United States Code, Section 2682. Also, the DFAS Columbus Center and the Defense Commissary Agency did not meet certain provisions of the Prompt Payment Act. No recommendations were made in this report; therefore, management comments were not required. However, we received comments from the Acting Chief Financial Officer. Management

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generally agreed with the report, but took exception to our reportable conditions on inadequate audit trails and reported instances of noncompliance with GAO Title 2; the Budget and Accounting Procedures Act of 1950; OMB Bulletin No. 93-02; and the National Defense Authorization Act.

Related Audit Reports

<u>Report No.</u>	<u>Title</u>	<u>Date</u>
General Accounting Office		
AIMD-96-54	Defense Business Operations Fund (DBOF): DoD Is Experiencing Difficulty in Managing the Fund's Cash (OSD Case No. 1109)	April 1996
AIMD-95-79	DBOF: Management Issues Challenge Fund Implementation (OSD Case No. 9859)	March 1, 1995
AIMD-94-80	Financial Management, Status of the DBOF (OSD Case No. 9339-D)	March 9, 1994
Inspector General, Department of Defense		
97-006	Major Accounting and Management Control Deficiencies in the DBOF in FY 1995	October 15, 1996
96-178	Internal Controls and Compliance with Laws and Regulations for the DBOF Consolidated Financial Statements for FY 1995	June 26, 1996
95-294	Major Accounting Deficiencies in the DBOF in FY 1994	August 18, 1995
95-267	DBOF Consolidated Statement of Financial Position for FY 1994	June 30, 1995

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95-072	Defense Finance and Accounting Service Work on the FY 1993 Air Force DBOF Financial Statements	January 11, 1995
95-067	Defense Finance and Accounting Service Work on the Air Force FY 1993 Financial Statements	December 30, 1994
95-066	Application Controls - Navy Inventories	December 30, 1994
95-034	Development of Property, Plant, and Equipment Systems	November 21, 1994
95-023	Application Controls Over Selected Portions of the Standard Army Intermediate Level Supply System	November 4, 1994
94-199	Research on Accounting and Financial Reporting at the Defense Information Services Organization	September 30, 1994
94-183	Controls Over Commissary Revenues	September 6, 1994
94-168	Defense Finance and Accounting Service Work on the Army FY 1993 Financial Statements	July 6, 1994
94-167	Selected Financial Accounts on the Defense Logistics Agency DBOF Financial Statements for FY 1993	June 30, 1994
94-163	Management Data Used to Manage the U.S. Transportation Command and Military Department Transportation Organizations	June 30, 1994
94-161	Consolidated Statement of Financial Position of the DBOF for FY 1993	June 30, 1994
94-159	Fund Balances With Treasury Accounts on the FY 1993 Financial Statements of the Defense Logistics Agency Business Areas of the DBOF	June 30, 1994

Appendix B. Summary of Prior Coverage

94-150	Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the DBOF for FY 1993	June 28, 1994
94-149	Property, Plant and Equipment Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the DBOF for FY 1993	June 28, 1994
94-147	Joint Logistics System Center's Financial Statements for FY 1993	June 24, 1994
94-128	Management Data Used to Manage the Defense Logistics Agency Supply Management Division of the DBOF	June 14, 1994
94-082	Financial Management of the DBOF-FY 1992	April 11, 1994
93-164	Financial Statements of DLA Supply Management Division of the DBOF (Defense Fuel Supply Center Financial Data) for FY 1992	September 2, 1993
93-153	DBOF Communication Information Services Activity Financial Statements for FY 1992	August 6, 1993
93-151	Compliance With the Federal Managers' Financial Integrity Act at the Defense Commercial Communications Office	July 26, 1993
93-147	Defense Commissary Resale Stock Fund Financial Statements for FY 1992	June 30, 1993
93-134	Principal and Combining Financial Statements of the DBOF for FY 1992	June 30, 1993

Appendix B. Summary of Prior Coverage

Army Audit Agency

AA 96-186	DBOF Depot Maintenance, Other, Army FY 95 Statement of Operations	June 13, 1996
AA 96-185	DBOF Supply Management, Army FY 95 Statement of Operations	April 30, 1996
NR 95-430	Army DBOF FY 94 Financial Statements	July 19, 1995
NR 94-471	Army DBOF FY 93 Financial Statements: Report of Management Issues	September 29, 1994
NR 94-470	Army DBOF FY 93 Financial Statements: Audit Opinion	June 30, 1994
NR 94-457	DBOF, FY 92 Financial Statements: Common Management Issues	March 30, 1994
NR 94-456	DBOF, Transportation, Army FY 92 Financial Statements: Report of Management Issues	March 30, 1994
NR 94-454	DBOF, Depot Maintenance, Army FY 92 Financial Statements: Report of Management Issues	March 30, 1994
NR 93-463	DBOF Depot Maintenance, Army	June 30, 1993
NR 93-462	DBOF Transportation, Army	June 30, 1993

Naval Audit Service

035-96	FY 1995 Consolidating Financial Statements of the Department of Navy DBOF	May 31, 1996
044-95	FY 1994 Consolidating Financial Statements of the Department of the Navy DBOF	May 30, 1995

Appendix B. Summary of Prior Coverage

010-95	Sponsor-Funded Equipment at Selected Navy DBOF Activities	December 2, 1994
053-H-94	FY 1993 Consolidating Financial Statements of the Department of the Navy DBOF	June 29, 1994
053-H-93	FY 1992, Consolidating Financial Statements of the Department of the Navy DBOF	June 30, 1993

Air Force Audit Agency

95068021	Review of Selected Accounts, Depot Maintenance Service Business Area FY 1995	September 13, 1996
95068020	Review of Selected Accounts, Supply Management Business Area, FY 1995	August 20, 1995
94068027	Followup–Audit–Review of Prior Year DBOF Recommendations	October 25, 1995
94068042	Followup–Audit–Review of Prior Year DBOF Recommendations	August 18, 1995
94068039	Review of Selected Accounts, Depot Maintenance Service Business Area, FY 1994	July 28, 1995
94068041	Review of Selected Accounts, Supply Management Business Area, FY 1994	June 27, 1995
93066011	Review of Application Controls Within the Depot Maintenance Equipment Program	November 16, 1994
93066012	Review of Application Controls Over Time and Attendance Reporting in Air Force Materiel Command Depot Maintenance Organizations	November 4, 1994

Appendix B. Summary of Prior Coverage

93066024	Review of Application Controls Within the Financial Inventory Accounting and Billing System	October 3, 1994
94068020	Opinion on Air Force DBOF, FY 1993 Fund Balances With Treasury	June 30, 1994
94068019	Opinion on Air Force DBOF, FY 1993 Property, Plant and Equipment Balances	June 30, 1994
94068018	Opinion on Air Force DBOF, FY 1993 Inventories Not Held for Sale Balance	June 30, 1994
94068017	Opinion on Air Force DBOF, FY 1993 Inventories Held for Sale Balance	June 30, 1994
93066023	Review of Application Controls Within the Depot Maintenance Actual Materiel Cost System	June 10, 1994
94068025	Air Force Depot Maintenance Service, FY 1993 Material In-Transit Balances	April 1, 1994
93068001	Compliance With Laws and Regulations and Management Issues Related to Air Force Supply Management and Distribution Depot, FY 1992 Financial Statements	December 15, 1993
92066008	Review of the Design and Development Activities for the Depot Maintenance Management Information System	August 18, 1993
93068024	Opinion on Air Force Consolidating Statements, DBOF, FY 1992 Financial Statements	June 30, 1993
93068012	Opinion on Air Force Distribution Depot, DBOF, FY 1992 Financial Statements	June 30, 1993

Appendix B. Summary of Prior Coverage

93068011	Opinion on Air Force Supply Management, DBOF, FY 1992 Financial Statements	June 30, 1993
92068003	Opinion on Laundry and Dry Cleaning Service, DBOF, FY 1992 Financial Statements	June 30, 1993
92068002	Opinion on Air Force Depot Maintenance, DBOF, FY 1992 Financial Statements	June 30, 1993
92071002	Opinion on Air Force Transportation, DBOF, FY 1992 Financial Statements	June 29, 1993
92066010	Review of General and Application Controls Within the Contract Depot Maintenance Production and Cost System	April 1, 1993
92066002	Review of General and Application Controls Within the Equipment Inventory, Multiple Status and Utilization Reporting Subsystem	April 1, 1993
92062001	Review of Depot Maintenance Industrial Fund Revenue Accounts, FY 1992 Financial Statements	February 28, 1993

Appendix C. Internal Control Structure

The internal control structure* consists of policies and procedures that provide reasonable assurance an organization's objectives will be achieved. In a financial statement audit, the auditors test the organization's ability to process, summarize, and report financial data consistent with auditing standards. The internal control structure is divided into three elements: the control environment, the accounting system, and the control procedures.

Control Environment. The control environment represents the organization's management approach that establishes, enhances, or mitigates the effectiveness of specific policies and procedures. The organizational structure, the board of directors, methods of assigning authority and responsibility, management's methods for monitoring and following up on performance, and personnel policies and practices are a few examples of how management affects the control environment. The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the organization.

Accounting System. The accounting system of an organization consists of the methods and records that identify, assemble, analyze, classify, record, and report transactions and maintain accountability for pertinent assets, liabilities, revenues, and expenses. Generally, an effective accounting system will ensure that an adequate audit trail exists to fully support a transaction.

Control Procedures. Control procedures are the policies and procedures used by management, in addition to the control environment and accounting system, to achieve the organization's objectives. Control procedures could include authorizing transactions and organizations, segregating duties,

*This definition of an internal control structure is from the American Institute of Certified Public Accountants "Codification of Statements on Auditing Standards," sections 319.06 through 319.11, January 1, 1994. In our opinion, this definition is all-inclusive and is synonymous with the definition of management controls as stated in Office of Management and Budget Circular No. A-123, June 21, 1995.

Appendix C. Internal Control Structure

safeguarding assets, and independently verifying the performance and proper valuation of recorded amounts.

A proper internal control structure lays the foundation for efficient and effective operations. By establishing the elements of a proper internal control structure management enhances its ability to obtain accurate, timely information to make informed decisions. With the firm commitment of management, a strong internal control structure can overcome existing deficiencies in an accounting system and permit the preparation and presentation of fairly stated financial statements.

Appendix D. Deficiencies Identified in FY 1996

Deficiencies Identified in FY 1996 by Inspector General, DoD

<u>Source</u>	<u>Description</u>	<u>Amount (Millions)</u>
IG, DoD, Project No. 5FJ-2011.03	PP&E universe data were not available to auditors and were material to the FY 96 financial statements.	\$2000.0
	DBOF equipment items could not be located.	274.6
	Equipment items lacked adequate documentation.	555.2
	PP&E assets were not recorded accurately in accounting records or included in financial reports.	1200.0
IG, DoD, Project No. 5FI-2016.03	DFAS Denver Center erroneously included prior-year expenses in the calculation of cost of goods sold on the FY 1996 Supply Management Business Area Statement of Operations.	4700.0
	The DFAS Denver Center inappropriately included \$3.2 billion of Depot-Level Repairable exchange credits twice in calculating cost of	3200.0

Appendix D. Deficiencies Identified in FY 1996

<u>Source</u>	<u>Description</u>	<u>Amount (Millions)</u>
	goods sold.	
	FY 1996 purchase at standard price transactions could not be validated for the Air Force.	9600.0
IG, DoD, Project No. 5FJ-2018	Military Department and DLA perpetual inventory records were misstated.	3900.0

Deficiencies Identified in FY 1996 by Army Audit Agency

Army Audit Agency Report AA 96-188	Capital Asset collections and disbursements were not separately recorded in Standard Depot System general ledger trial balances.	62.9
	The Inventory, Net, line on the Army's FY 1995 financial statements was overstated, and thus understated the loss shown as operating results. Future year's operations will be misstated when such gains or losses are recognized.	1700.0
	End of FY 1995 Inventory was understated, causing Cost of Goods Sold to be overstated. Because the understated beginning inventory for FY 1996 was not adjusted, the Cost of Goods Sold was also	1200.0

Appendix D. Deficiencies Identified in FY 1996

<u>Source</u>	<u>Description</u>	<u>Amount (Millions)</u>
	understated for FY 1996.	
	Controls over recording and reporting Inventory-in-Transit were not adequate to ensure that all transactions in the account were valid.	420.0
	The validity of certain asset and liability account balances was questioned.	1800.0

Deficiencies Identified in FY 1996 by Naval Audit Service

Naval Audit Service Draft Report No. 96-0002	Inventory Records were misstated due to various human errors.	15.3
	Accounts Payable, Federal, were inappropriately purged.	87.7
	Federal Liabilities were misclassified as Non-Federal.	188.2
	Navy accounting records included transactions without documentation.	66.7
	Aged accounts were not properly followed up as required by DoD guidance.	35.6
	Accounts Payable, Federal, were misstated; due mainly to	43.9

Appendix D. Deficiencies Identified in FY 1996

<u>Source</u>	<u>Description</u>	<u>Amount (Millions)</u>
	accounting systems control deficiencies.	

Deficiencies Identified in FY 1996 by Air Force Audit Agency

Air Force Audit Agency Project 96068001	Depot Maintenance Business Area accumulated net negative intransit balances and misstated value of materials inventory asset account.	142.4
	Trial balances misstated unearned revenue accounts in the Depot Maintenance Business Area.	130.8
	Air Force Materiel Command labor and payroll systems lacked automated procedures to reconcile labor costs.	14.9
	Air Logistics Command personnel inadequately monitored the timeliness, completeness, and accuracy of contractor Government Furnished Material and repair completion reporting.	118.0
	Depot Maintenance Business Area managers did not provide adequate approval and oversight controls over their	566.3

Appendix D. Deficiencies Identified in FY 1996

<u>Source</u>	<u>Description</u>	<u>Amount (Millions)</u>
	business practices, allowing unnecessary material costs.	
Air Force Audit Agency Project 96068004	The Supply Requirements System's default estimated repair prices did not reflect actual costs.	225.9
	Air Force systems did not correctly compute and distribute carcass prices.	103.3
Air Force Audit Agency Project 96068009	Personnel recorded transactions in the wrong accounting period.	257.7
Air Force Audit Agency Project 96068011	Accountants did not record cash collections and disbursements in the period the transactions occurred.	26700.0
	Depot Maintenance Business Area organizations did not maintain and reconcile subsidiary ledgers for property account balances as required.	1500.0
	Air Logistics Command did not retain appropriately detailed records to support historical cost and accumulated depreciation account balances.	925.0
	The equipment trial balance account was understated.	88.9

Appendix D. Deficiencies Identified in FY 1996

<u>Source</u>	<u>Description</u>	<u>Amount (Millions)</u>
Air Force Audit Agency Project 96068013	The Wholesale and Retail Receiving System did not retain support documentation for sales transactions.	248.0
	The Financial Inventory and Accounting Billing System did not retain accounting control numbers for sales and sales returns.	86.1
	Supply Management base-level financial and supply systems did not provide adequate audit trails to validate the accuracy of sales and sales returns.	2823.0
	DFAS personnel at Air Logistics Command did not properly research and document the sales clearing account and associated sales and accounts receivable accounts.	99.0
	DFAS could not perform the monthly validation tracing of accounts receivable to subsidiary ledgers.	163.8

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Acquisition and Technology)
Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Public Affairs)

Department of the Army

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

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
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 Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division,
General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

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 National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Under Secretary of Defense (Comptroller) Comments

September 5, 1997

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

SUBJECT: A Status Report on the Major Accounting and Management Control Deficiencies
in the Defense Business Operations Fund for FY 1996 (Project No. 5FH-2015.02)

This memorandum is in response to your request for comments on the subject draft audit report, dated June 30, 1997. This is a combined response from the Office of the Under Secretary of Defense (Comptroller) and the Defense Finance and Accounting Service.

It should be recognized that management responsibility for the individual Defense Working Capital Funds (DWCF) resides with the DoD Components—not the Under Secretary of Defense (Comptroller) or the Defense Finance and Accounting Service (DFAS). Additionally, many of the problems highlighted in the audit report existed prior to, and are caused by system deficiencies that predate, the existence of the DFAS. However, the audit report fails to acknowledge these factors.

This office acknowledges that the Department lacks the best and the newest systems and that the Department's existing systems do not always capture all of the data required to make the job easier. However, this audit report appears to simply list known problems, while failing to provide new information or offering new substantive recommendations for resolving problems that the Department is working, diligently, to resolve. Further, the audit report provides little sense of perspective or context and promotes—although perhaps unintentionally—the impression that the financial statements are assembled without any valid data. The offering of proposed specific new solutions, or acknowledgment that existing planned efforts are expected correct the stated problems, would have resulted in a more useful audit report.

Additional general comments addressing erroneous statements that are contained in the audit report are provided in attachment 1. Specific comments concerning the recommendation, with which this office partially concurs, are provided in attachment 2.

Mr. John Glover is my staff contact on this matter. He may be reached at e-mail: gloverj@ousdc.osd.mil or at (703) 697-0537.

signed

Nelson Teye
Deputy Chief Financial Officer

Attachments

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)

Draft Audit Report "A Status Report on the Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund for FY 1996"(Project No. 5FH-2015.02)

GENERAL COMMENTS

* * * * *

Page 3, Changes to DBOF, second paragraph: Four separate working capital funds were established, not five. The Defense Commissary Agency is included in the Defense-Wide working capital fund and is not a separate fund.

Page 2

Page 8, Accounting Systems: The DFAS operates a substantial number of accounting and finance systems that may or may not electronically interface with each other; thus, processing data timely and accurately between systems within the very constrained time limits for the reports is difficult and labor intensive. However, DFAS is committed to resolving these systems problems. The Defense Accounting System Program Management Office (PMO) was established to manage the consolidation and modernization of all DFAS accounting systems. A long-term goal of the PMO is to reduce the DoD accounting systems from more than 200 nonstandard accounting systems to 23 standard accounting and finance systems by the year 2003.

Additionally, the DFAS is responsible for the accounting and finance systems, but it is not responsible for all systems that provide feeder data for financial reporting purposes. Other functional areas, such as acquisition, medical, logistics, and personnel, originate and process data that eventually are reported on the financial statements. These data are generated by nonaccounting and finance systems and are the responsibility of the DoD Components. The DFAS is committed to the accurate and timely preparation of its financial statements within current systems limitations. DFAS is taking many actions to improve the quality of our financial statements and to overcome deficiencies in the near term.

Page 11, Cash Management, second paragraph: This paragraph contains some inaccurate statements and is misleading. The amounts cited are the entire amounts of disbursements and collections made against the Air Force DBOF for the entire fiscal year. Therefore, the OIG appears to be stating that *none* of the disbursements and collections during FY 1996 for the Air Force DBOF were recorded in the period when the transactions occurred. Such a statement obviously is in error. Further, this office believes that all of the collections and disbursements reported to the Treasury in FY 1996 also were reported in the FY 1996 CFO Financial Statements, in that same fiscal year period. This office acknowledges that some of the collections and disbursements may not have been reflected in financial statements for the lower level applicable business areas or activity level financial management reports until after the period in which the transactions occurred and were reported to the Treasury.

Under Secretary of Defense (Comptroller) Comments

Nevertheless, such disbursements and collections were included in the applicable DoD Component's working capital fund. Further, the DFAS is committed to providing improved cash management tools to the working capital fund managers and will provide weekly estimated cash reports to assist in the management of working capital fund cash balances.

In addition, cash management issues were discussed in the recently completed study of the Defense Working Capital Fund. The study group recommended that the Services develop cash management models. Another working group will be established to review existing cash models and develop requirements for an automated model for accounting systems. The USD(C) review group recommended the development of a real time cash management information system. This is a long-term goal. And while the development of cash models should improve cash management in the DWCF, some of the uncertainties of cash reporting relate to a lack of timely and accurate information and reports—some involving transactions emanating from outside the DFAS controlled accounting systems.

Page 12, Standard General Ledger, second paragraph: The final published FY 1996 Chief Financial Officers (CFO) Act financial statements did not include \$4.7 billion of prior period expenses in the calculation of cost of goods sold for the FY 1996, Air Force Supply Management business area as indicated in the report. The potential error referenced in the audit report was detected and corrected by the Air Force and DFAS prior to the publication of the financial statements. Without clarifying this situation, the reader of the report is left with the understanding that the FY 1996 CFO financial statements are incorrect. Additionally, it should be noted that, in a memorandum dated July 30, 1997, the Acting Under Secretary of Defense (Comptroller) advised the DoD financial community that the Department was converting to the U.S. Government Standard General Ledger.

OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)

**Draft Audit Report "A Status Report on the Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund for FY 1996"
(Project No. 5FH-2015.02)**

RECOMMENDATIONS

* * * * *

RECOMMENDATION 1: The DoDIG recommended that the Under Secretary of Defense (Comptroller) (USD(C)) conduct periodic reviews of all issues affecting the Defense Working Capital Fund (DWCF), with participants drawn from all Military Departments and Defense Agencies. The reviews should be similar to the FY 1997 Defense Working Capital Fund Study initiated by the USD(C) in response to the FY 1997 Defense Authorization Act.

OUSD(C) RESPONSE: Partially Concur. This office agrees that, when significant DWCF accounting and management control deficiencies are identified, such deficiencies should be reviewed by the USD(C) and the Defense Finance and Accounting Service, in conjunction with representatives from the appropriate Military Department or Defense Agency. However, this office does not agree that such reviews need to be as formal and structured as the Defense Working Capital Fund Study required by the FY 1997 Defense Authorization Act. Initiating such formal and structured reviews would not be necessary, or effective, and could require the expenditure of considerable resources out of proportion to the expected benefits.

In addition, the Office of the USD(C) conducts quarterly budget execution reviews and meets at least twice each month with representatives of the Military Departments and the Defense Agencies. During these meetings, the DoD Components discuss the status of financial operations, including problems and proposed resolutions of accounting issues. Representatives from the Defense Finance and Accounting Service (DFAS) attend quarterly briefings, and actions taken by DFAS to correct financial operations are usually discussed. Therefore, it does not appear to be necessary to undertake additional, large-scale, formal and structured studies similar to the one conducted in response to the requirements contained in the FY 1997 Authorization Act.

Audit Team Members

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

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