Audit Report

INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR THE FY 1997 DEFENSE INFORMATION SYSTEMS AGENCY WORKING CAPITAL FUND FINANCIAL STATEMENTS

Report Number 98-162 June 24, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CFO	Chief Financial Officers
CISA	Communications Information Services Activity
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DISA	Defense Information Systems Agency
DISA WESTHEM	Defense Information Systems Agency-Western Hemisphere
DMC	Defense Megacenter
DPAS	Defense Property Accountability System
FFMIA	Federal Financial Management Improvement Act
IFAS	Industrial Fund Accounting System
IG	Inspector General
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
USGSGL	United States Government Standard General Ledger
WCF	Working Capital Fund

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June 24, 1998

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

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and Regulations for the FY 1997 Defense Information Systems Agency Working Capital Fund Financial Statements (Report No. 98-162)

We are providing this report for review and comments. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspector General. Our responsibility is to issue an opinion on the financial statements. On February 27, 1998, we issued a disclaimer of opinion on the FY 1997 Defense Information Systems Agency Working Capital Fund Financial Statements. Our disclaimer of opinion and the principal statements are included in Appendix C. We identified internal control weaknesses and instances of noncompliance with laws and regulations that merit management's attention. Part I discusses internal controls and compliance with laws and regulations. Part II provides relevant appendixes for management's use.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Directors of the Defense Information Systems Agency and the Defense Finance and Accounting Service did not comment on a draft of this report. We request that the Defense Information Systems Agency and the Defense Finance and Accounting Service provide comments on the recommendations, as well as the material weaknesses identified in Appendix A by July 24, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David F. Vincent, Audit Program Director, at (703) 604-9110 (DSN 664-9110), e-mail dvincent@dodig.osd.mil, or Mr. John A. Richards, Audit Project Manager, at (703) 604-9133 (DSN 664-9133), e-mail jrichards@dodig.osd.mil. See Appendix F for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Report No. 98-162 **June 24, 1998**
(Project No. 8FH-2003.01)

Internal Controls and Compliance With Laws and Regulations for the FY 1997 Defense Information Systems Agency Working Capital Fund Financial Statements

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 revolving funds such as the Defense Information Systems Agency Working Capital Fund (the Fund). The Chief Financial Officers Act of 1990 prescribes the responsibility of management and auditors with respect to the financial statements, internal controls, and compliance with laws and regulations. In FY 1991, the revolving funds were consolidated to form the Defense Business Operations Fund. In December 1996, the Under Secretary of Defense (Comptroller) started a process to restructure the Defense Business Operations Fund into eight separate working capital funds. The Inspector General, DoD, is responsible for auditing and rendering an opinion on the financial statements, for FY 1997 and subsequent years, of the eight working capital fund reporting entities.

The Fund is one of the eight working capital fund reporting entities. The Defense Information Systems Agency provides communication and information services, common-user computer processing for the DoD and others. In FY 1997, the Defense Information Systems Agency reported assets and liabilities valued at $880 million and $545.4 million, respectively. Revenue from operations was $2,449.7 million. The program manager responsible for this fund is the Director, Defense Information Systems Agency. The Defense Information Systems Agency and the Defense Finance and Accounting Service are responsible for establishing and maintaining adequate internal controls and for complying with applicable laws and regulations. Our responsibility is to express an opinion on the financial statements based on our audit, and to determine whether internal controls were adequate and whether management complied with applicable laws and regulations.

Audit Objectives. The overall audit objective was to determine whether the FY 1997 Defense Information Systems Agency Defense-Wide Working Capital Fund Financial Statements are presented fairly and in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. We also assessed internal controls and compliance with laws and regulations. Our review provided a reasonable basis for determining the adequacy of the internal controls and compliance with laws and regulations as they relate to the financial statements.

Disclaimer of Opinion. We were unable to render an opinion on the FY 1997 Fund's Financial Statements because the scope of audit was limited. The scope limitation affected our audit work as follows:

- Deficiencies in DoD accounting systems resulted in substantial undistributed collections and undistributed disbursements for the Defense Megacenters. The undistributed amounts were allocated by the Defense Finance and Accounting Service to the Accounts Receivable balance and the Accounts Payable balance. As a result, at least $435.1 million of the balances were unverifiable.

- We were unable to reconcile the beginning and ending consolidated balances for the Property, Plant, and Equipment account. We requested that Defense Information Systems Agency personnel review the financial statement balances and explain changes; however, they were unable to reconcile the changes of $78.5 million shown on the financial statements with the beginning and ending balances.

Internal Controls. Internal controls need to improve accounting for and managing resources, ensuring compliance with laws and regulations, and ensuring that the financial statements are free of material misstatements. The Defense Finance and Accounting Service needs to improve the processing and reconciliation of undistributed transactions (Finding A). In addition, management needs to strengthen internal controls over accounting for and tracking property, plant, and equipment (Finding B). Our review would not necessarily disclose all reportable conditions that might also be considered material weaknesses. See Appendix A for details on the management control program.

Compliance With Laws and Regulations. Management generally complied with laws and regulations related to the financial statements. However, improved compliance is needed for the $50 million in reported contingent liabilities, the $7 million in accrued sick leave for the Communications Information Services Activity, and in accounting for the unbillable costs of services for the Defense Megacenters (Finding C). Finally, the financial management systems did not comply with Federal requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. With respect to items not tested, we found nothing that caused us to believe that management had not complied in all material respects with the provisions previously identified.

Summary of Recommendations. The Director, Defense Finance and Accounting Service, should proceed with corrective actions for the reported material weakness regarding the processing of undistributed and unmatched cross disbursing and Interfund transactions. The Director, Defense Information Systems Agency, as soon as feasible, should reconcile the records supporting the undistributed balances with the accounting records. The Director, Defense Information Systems Agency, should also improve interfaces and reconciliations between the Defense Property Accountability System and the general ledger accounting system so that summary level data in the general ledger is supported by detailed data in the Defense Property Accountability System. Finally, the Director, Defense Information Systems Agency, should implement the accounting standards and correct financial statements with regard to contingent liabilities, accrual of sick leave, and accrual of costs for services.

Management Comments. The Directors of the Defense Information Systems Agency and the Defense Finance and Accounting Service did not respond to a draft of this report. We request that the Director, Defense Finance and Accounting Service, and the Director, Defense Information Systems Agency, provide comments on the final report by July 24, 1998.

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Part I - Audit Results

Audit Background

Introduction. The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires annual audits of funds such as the Defense Information Systems Agency Working Capital Fund (the Fund). The CFO Act of 1990 prescribes the responsibility of management and auditors with respect to the financial statements, internal controls, and compliance with laws and regulations. The legislation requires financial statement audits by the Inspectors General and prescribes the responsibility of management and the auditors with respect to the financial statements, internal controls, and compliance with laws and regulations. The Defense Information Systems Agency (DISA) and the Defense Finance and Accounting Service (DFAS) are jointly responsible for the information contained in the DISA Working Capital Fund Financial Statements for the fiscal years 1997 and 1996. Our responsibility is to render an opinion on those statements based on our audit. The DISA provides communication and information services and common-user computer processing for the DoD and others. In FY 1997, DISA reported assets and liabilities valued at $880 million and $545.4 million, respectively. Revenue from operations was $2,449.7 million.

Accounting Policies. The DISA Working Capital Fund (WCF) Financial Statements for the fiscal years 1997 and 1996 were to be prepared in accordance with the Office of Management and Budget (OMB) Bulletin 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by OMB Bulletin 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. These bulletins incorporate the concepts and standards contained in the Statements of Federal Accounting Concepts and Standards recommended by the Federal Accounting Standards Board, which are approved by the Secretary of the Treasury; the Director, OMB; and the Comptroller General of the United States. Footnote 1 of the DISA Defense-Wide WCF Financial Statements discusses the significant accounting principles used to prepare the financial statements.

Disclaimer of Opinion. We were unable to render an opinion on the FY 1997 Fund's Financial Statements because the scope of audit was limited. The scope limitation affected our work as follows:

- Deficiencies in DoD accounting systems resulted in substantial undistributed collections and undistributed disbursements for the Defense Megacenters (DMCs). The undistributed amounts were allocated by DFAS to the Accounts Receivable balance and the Accounts Payable balance. As a result, significant portions of the balances were unverifiable.

- We were unable to reconcile the beginning and ending consolidated balances for the Property, Plant, and Equipment account. We requested that Defense Information Systems Agency personnel review the financial statement balances and explain changes; however, they were unable to reconcile the changes shown on the financial statements with the beginning and ending balances.

We reviewed the internal controls of the Fund and assessed compliance with the laws and regulations related to the financial statements. See Appendix C for the Principal Statements, Footnotes, and the Audit Opinion.

Working Capital Funds. A WCF is a revolving fund that operates as an accounting entity. Within each WCF, there are business areas or activity groups, such as Supply Management, that are financed through customer reimbursement rather than direct appropriations. Assets of each business area are capitalized under the WCF and most income is derived from offsetting collections derived from fund operations.

Before FY 1992, the DoD operated a significant number of commercial and industrial facilities under a revolving fund concept. In FY 1992, the revolving funds were consolidated to form the Defense Business Operations Fund (DBOF). The Inspector General (IG), DoD, was responsible for auditing and rendering an opinion on the DBOF consolidated financial statements. In December 1996, the Under Secretary of Defense (Comptroller) restructured the DBOF into separate WCFs.

Audit Objectives

The overall audit objective was to determine whether the FY 1997 DISA WCF Financial Statements are presented fairly and in accordance with OMB Bulletin No. 94-01, as modified by OMB Bulletin No. 97-01. We also assessed internal controls and compliance with laws and regulations. Our review provided a reasonable basis for determining the adequacy of the internal controls and compliance with laws and regulations as they relate to the financial statements. Part I.A. contains our report on internal controls. Part I.B. contains our report on compliance with laws and regulations. Appendix A provides discussion on scope, methodology, auditing standards, accounting principles, and management control program. Appendix B provides a summary of prior audit coverage.

Part I.A. - Review of Internal Controls

Introduction

Audit Responsibilities. Our audit objective was to determine whether controls over transactions supporting the accounts in the FY 1997 financial statements were adequate to ensure that the accounts were free of material misstatements. In planning and performing our audit of the Fund accounts for the year ended September 30, 1997, we evaluated the internal controls. We performed this evaluation to:

- determine the auditing procedures necessary to express an opinion on the financial statements; and
- determine whether internal controls had been established.

Management Responsibilities. Management is responsible for establishing and maintaining the internal controls of the Fund. The responsibility requires management to make estimates and judgments to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable but not absolute assurance that:

- transactions are properly recorded and accounted for in order to prepare reliable financial statements and to maintain accountability over assets;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and
- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and are in compliance with any other laws and regulations that the OMB, entity management, or the Inspector General, DoD, have identified as being significant for objectively measuring and evaluating compliance.

Internal Control Elements. DoD Directive 5010.38, "Management Control Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996, require management to establish and maintain a comprehensive management control system, including internal controls, and monitor and report on the system. The internal control structure consist of three elements.

- Control environment is the collective effort of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include management's philosophy and operating style, the entity's organizational structure, and personnel policies and practices. The control environment

reflects the overall attitude, awareness, and actions of management concerning the importance of controls and the emphasis placed on them by the entity.

- Accounting and related systems are those methods and records established to identify, assemble, analyze, classify, record, and report on the entity's transactions and to maintain accountability for the related assets and liabilities.

- Control procedures are the policies and procedures in addition to the control environment and accounting and related systems that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Reportable Conditions

Our review of the internal controls for the FY 1997 Fund's Financial Statements disclosed material internal control weaknesses as defined by DoD Directive 5010.38. We also identified conditions that we considered to be reportable under OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, as modified by OMB Bulletin No. 98-04, "Addendum to OMB Bulletin No. 93-06," January 16, 1998. OMB Bulletin No. 98-04 was effective for financial statements for the year ended September 30, 1997. To implement the required changes, OMB issued a memorandum on September 9, 1997, providing implementation guidelines. In planning and performing our audit tests, we considered the implementation guidelines issued September 9, 1997. Reportable conditions are significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure the preparation of reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operations of the internal controls do not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would occur to an extent that would be material to the statements being audited, and would not be detected within a timely period by employees in the normal course of performing their functions.

Our consideration of the internal controls would not necessarily disclose all reportable conditions and would not necessarily disclose all reportable conditions that are considered to be material weaknesses. See Appendix A for management controls assessed.

DISA Material and Reportable Conditions. Internal controls for the Fund were not adequate. A material internal control weakness existed in the processing and reporting of undistributed collections and disbursements (Finding A). As a result, the Accounts Receivable and Accounts Payable balances of the Defense Megacenters (DMCs) were unverifiable. Another material internal control weakness was accounting for Property, Plant, and

Equipment of the DMCs (Finding B). The inadequacy of crosswalk support or audit trail provided by DFAS Cleveland Center for the DMCs Statement of Cash Flows was a reportable internal control weakness. Because of the inadequacies in internal controls, we could not determine whether all errors were detected in the accounts involved; therefore, we could not determine whether the account balances were fair and reasonable.

Management Actions. The internal control weaknesses were a major factor in the disclaimer of opinion issued for the FY 1997 DISA Defense-Wide WCF Financial Statements. Both the Director, DISA, and Chief Financial Officer, DISA, candidly recognized the extent of the deficiencies in the reporting of Accounts Receivable and Accounts Payable balances, as cited in the FY 1997 Management Representation Letter. See Appendix D for the management representation letter. The Defense Finance and Accounting Service has undertaken corrective actions addressing the weakness in processing undistributed collections and disbursements. Similarly, DISA has undertaken corrective actions intended to address the weakness in accounting for Property, Plant, and Equipment.

Finding A. Undistributed Collections and Disbursements

DMCs undistributed collections and disbursements were not reconciled with the reporting entity's accounting records. Specifically, the fiscal yearend balances in these accounts were netted against Accounts Receivable and Accounts Payable balances reported in the financial statements. Because the accounting details for the consolidated data reported to the Department of the Treasury were not concurrently available to the reporting entity and reports to the Department of the Treasury bypassed the financial controls of the reporting entity, the accounting systems and procedures were not adequate to enable DFAS to reconcile undistributed balances. As a result, the Accounts Receivable and Accounts Payable balances were reduced a total of $435.1 million, and were unverifiable and unauditable.

DoD Guidance. The DoD Regulation 7000.14-R, "Department of Defense Financial Management Regulation," provides guidance for treatment of undistributed balances of the DBOF on the CFO statements but does not provide explicit guidance for the treatment of such balances in, for example, working capital funds. The DBOF guidance exists even though DBOF was discontinued in December 1996. The DoD Regulation 7000.14-R, volume 4, "Accounting Policy and Procedures," chapter 2, "Accounting for Cash and Fund Balances with Treasury," January 1995, indicates that general guidance for using undistributed accounts will be published later. The DoD Regulation 7000.14-R, volume 11B, "Reimbursable Operations, Policy and Procedures--Defense Business Operations Fund, chapter 54, "Cash, Receivables, Advances, and Cash Management," December 1994, provides that remaining balances in Undistributed Collections and Undistributed Disbursements accounts for the DBOF shall be transferred to Accounts Receivable and Accounts Payable, respectively. DoD Regulation 7000.14-R, volume 6, "Reporting Policy and Procedures," chapter 6, "Form and Content of Audited Financial Statements," January 1998, although not referring to undistributed balances directly, provides that differences between the Fund Balance with Treasury reported in the CFO statements and the amount reported on Financial Management Service Form 2108 "Year End Closing Statement" must be explained.

The DoD guidance for DBOF treatment of undistributed accounts was selected for use in preparing the current fiscal year Statement of Financial Position. Transferring the Undistributed Collections credit balance of $97.7 million to the existing DMCs Accounts Receivable debit balance of $165.7 million produced a closing debit balance of $68 million. Similarly transferring the Undistributed Disbursements debit balance of $337.4 million to the existing DMCs Accounts Payable credit balance of $287.1 million produced a closing debit balance of $50.3 million.

The effect of transferring the Undistributed Collections balance to Accounts Receivable was to reduce the Consolidated Accounts Receivable balance by 18.4 percent ($97.7 million of $530.6 million). The effect of transferring the

Undistributed Disbursements balance to Accounts Payable was to reduce the Consolidated Accounts Payable balance by 42.1 percent ($337.4 million of $801.1 million).

DFAS Cleveland could provide no information regarding the make-up of the undistributed balances except that they were mostly attributable to problems involving cross disbursing and Interfund data. Therefore, the effects of undistributed balances on this audit are that 18.4 percent of the value of Consolidated Accounts Receivable and 42.1 percent of the value of Consolidated Accounts Payable are unauditable.

DFAS has reported the processing of undistributed and unmatched cross disbursing and Interfund transactions as a DoD-wide problem and as a material weakness in its FY 1997 Annual Statement of Assurance. The target date for correction of the weakness is FY 1999.

Recommendations for Corrective Action

A.1. We recommend that the Director, Defense Finance and Accounting Service, proceed with corrective actions regarding the reported material weakness in the processing of undistributed and unmatched cross disbursing and Interfund transactions.

A.2. We recommend that the Director, Defense Information Services Agency, in conjunction with the Director, Defense Finance and Accounting Service, reconcile the transactions in the Undistributed Collections and Undistributed Disbursements accounts of the Defense Megacenters with the entity's accounting records.

Management Comments Required

Neither the Defense Finance and Accounting Service nor the Defense Information Systems Agency commented on a draft of this report. We request that both organizations provide comments on the final report.

Finding B. Accounting for Property, Plant, and Equipment

The Property, Plant, and Equipment account balances could not be tracked during the fiscal year. Specifically, the beginning balance of DMCs equipment could not be reconciled to the ending balance, and the monthly trial balance could not be reconciled from month to month or to the DMCs property book, Defense Property Accountability System (DPAS). A defective electronic interface between the DPAS and the general ledger system caused incorrect postings to depreciation and fixed asset accounts. In addition, regular periodic reconciliations were not performed to correct the errors. The result was that we were unable to audit the Property, Plant, and Equipment line item.

Background. The Property, Plant, and Equipment line item on the Consolidated Statement of Financial Position ($226.7 million) represents 26 percent of the DISA WCF total assets. It equals the sum of the DMCs and the Communications Information Services Activity (CISA) Property, Plant, and Equipment values, $198 million and $28.7 million, respectively.

The CISA equipment is maintained, accounted for, and reported by the Defense Information and Technology Contracting Office. The reported balance is derived from the Performance Asset Management system, a module of the Defense Information and Technology Contracting Office accounting system, Financial Accounting Management Information System. The Performance Asset Management system maintains acquisition data, tracks depreciation, and produces summary reports. The Defense Information and Technology Contracting Office reconciled the Performance Asset Management account balances to the general ledger at year's end.

Each of the 16 DMCs maintained and reported Property, Plant, and Equipment, by using DPAS. DPAS was implemented to record the acquisition cost, to accrue depreciation, and to report the value of all capital assets. An electronic interface between DPAS and the DMCs accounting system, Industrial Fund Accounting System (IFAS), was designed to facilitate postings to the general ledger accounts. Via the interface, all DPAS transactions are to be electronically posted directly to both the individual Defense Megacenter and to aggregate DMCs trial balances in IFAS.

Interface Problems. According to DISA officials, DPAS, a single entry property management system, does not properly interface with double entry accounting systems like IFAS. This defective interface caused incorrect postings to general ledger accounts (fixed assets, software, depreciation, assets in use, assets not in use). DISA personnel had difficulty in reconciling their ledgers with DPAS and did not understand why the interface was defective.

Reconciliation Efforts. Although DISA and DFAS personnel were aware of the interface problems described, efforts to reconcile DPAS and IFAS variances were not consistent. Financial personnel at one of the DMCs attempted a monthly reconciliation, during the year, but were unsuccessful and thus, ineffective, because of their inexperience with DPAS.

After inventorying DMCs capital equipment, DISA determined that the DPAS balances were generally correct. Similarly, from our inventory of samples of DPAS equipment, we concluded the equipment quantities data were generally accurate. On two occasions during FY 1997, DFAS accountants made correcting entries to the Property, Plant, and Equipment accounts in order to match them with the DPAS balances, but because the interface was the source of the errors, the imbalances continued to occur. The DFAS accountants did not make an adjusting entry at the year-end, and, as a result, the IFAS balance was $2.1 million less than DPAS.

Accounting Guidance. DoD Regulation 7000.14-R, volume 6, chapter 6, requires the accurate representation of Property, Plant, and Equipment balance on line 1.k of the Statement of Financial Position.

Potential Corrective Actions. We acknowledge that these issues were recently reviewed by the General Accounting Office Report No. AIMD-97-150 (OSD Case 1444), "DoD's Approach to Financial Control Over Property Needs Structure," September 1997. See Appendix B for discussion of this report.

During our audit, DISA financial analysts, logistics specialists, and computer programmers were collaborating to determine the correct computer mapping for the electronic interface between DPAS and IFAS. In addition, the Director, DISA, issued draft procedures for reconciling the individual and consolidated DMCs property balances with trial balance accounts. Since neither of the efforts has been completed, followup will be required to determine their effectiveness in subsequent reporting.

Because efforts at tracking property balances during the period, reconciling beginning and ending balances, and making account balance comparisons between the current and prior periods were ineffective when using IFAS account balances, we were unable to verify 87 percent, or $198 million, of the reported value of DISA Property, Plant, and Equipment.

Recommendation for Corrective Action

B. We recommend that the Director, Defense Information Systems Agency, establish procedures for at least bimonthly reconciliation of Defense Property Accountability System balances with Industrial Fund Accounting System trial balances.

Management Comments Required

The Defense Information Systems Agency did not comment on a draft of this report. We request the agency to provide comments on the final report.

Part I.B. - Review of Compliance with Laws and Regulations

Introduction

We evaluated the Fund's Financial Statements for material instances of noncompliance with laws and regulations for the year ending September 30, 1997. Our audit objective was to assess compliance with laws and regulations for transactions and events that could have a direct and material effect on the financial statements. Such tests are required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We reviewed compliance with laws and regulations to obtain reasonable assurance that the financial statements were free of material misstatements, not to render an opinion on overall compliance with such provisions. See Appendix E for a list of the laws and regulations we reviewed. The Chief Financial Officer, DoD; Director, DISA; and the Director, DFAS, are all responsible for ensuring compliance with laws and regulations applicable to the Fund.

Material Noncompliances

Material instances of noncompliance are failures to follow requirements, laws, or regulations that would cause us to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements or that the sensitivity of the matter would cause others to perceive it as significant. The results of our reviews indicate that, with exceptions, management generally complied with the selected provision of laws and regulations as they pertain to the accuracy of the financial statements. The noncompliance with guidance regarding contingent liabilities of the CISA was material.

DISA Compliance Issues. We identified instances of noncompliance with regulations within the Fund (see Finding C) pertaining to CISA contingent liabilities, the unbillable costs of services provided to DMCs customers, and the accrual of sick leave expense for CISA employees. Additional regulations that were not complied with relate to the description for DMCs capital leases in the financial statements, as well as the regulation related to the internal control weaknesses addressed in Part I.A., namely, DoD Regulation 7000.14-R, volume 1, "General Financial Management Information, Systems, and Requirements," chapter 3, "Accounting Systems Conformance, Evaluation, and Reporting," May 1993.

DMCs Capital Lease Compliance. Footnote O on the Fund's Statements indicates "no capital leases related to DISA-DWCF operations." However, capital leases valued at $2.9 million were included in Property, Plant, and Equipment balances; and the FY 1997 depreciation charge was $529,000. No description of capital leases was provided in Note 18 as required by the DoD Regulation 7000.14-R, volume 6, chapter 6.

Federal Financial Management Improvement Act of 1996 Compliance. On September 9, 1997, the OMB issued a memorandum, "Implementation Guidance for the Federal Financial Management Improvement Act (FFMIA) of 1996." The FFMIA requires each Federal agency to implement and maintain

financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger (USGSGL) at the transaction level. The FFMIA also requires that we report on agency compliance with these requirements.

These requirements are already well-established in Federal policy documents to include:

- OMB Circular No. A-127, "Financial Management Systems," July 23, 1993, establishes Government policy for developing, evaluating, and reporting on financial management systems. It requires financial management systems to provide complete, reliable, consistent, timely, and useful financial management information. To achieve this goal, DoD and other Federal agencies must establish and maintain a single, integrated financial management system, that uses the USGSGL.

- OMB Circular No. A-134, "Financial Accounting Principles and Standards," May 20, 1993, establishes policies and procedures for approving and publishing financial accounting principles and standards. It also establishes the policies to be followed by Executive agencies and OMB in seeking and providing interpretations and other advice related to the standards.

- The JFMIP Federal Financial Management Information Program (JFMIP) is a cooperative undertaking of the OMB, the Department of the Treasury, and the Office of Personnel Management, working in cooperation with each other and with operating agencies to improve financial management practices throughout the Government. The JFMIP has published a series of "Federal Financial Management System Requirements."

- The "Core Financial System Requirements," September 1995, which are a part of the JFMIP's "Federal Financial Management System Requirements," establish standard requirements for the foundation modules of an agency's integrated financial management system. These requirements state that a financial management system must support the partnership between program and financial managers and assure the integrity of information for decisionmaking and performance measurements.

As part of our audit to obtain reasonable assurance that the FY 1997 Fund's Financial Statements were free of material misstatement, we performed tests of their compliance with certain provisions of laws and regulations when noncompliance with these laws and regulations could have a direct and material effect on determining amounts in the financial statements. We also tested compliance with certain other laws and regulations specified in OMB Bulletin 93-06, as modified by OMB Bulletin No. 98-04.

For FY 1997, the financial management systems that support the Fund's Financial Statements were not in substantial compliance with the requirements of the FFMIA. The DoD financial management systems comprise multiple

finance, accounting, and feeder systems that are the responsibility of DFAS, the Military Departments, and the Defense agencies. DoD financial management systems were unable to produce auditable and timely financial statements for FY 1997 primarily because the accounting and related systems were not designed for financial reporting. The financial condition of DoD and its operating results for FY 1997 were not verifiable, and DoD had no assurance that it was properly managing its resources.

Weaknesses in DoD accounting systems have been reported since the inception of the DBOF. Data from the deficient systems were used to prepare the Fund financial statements. DFAS and DISA acknowledged that the primary accounting and financial systems used to report the financial statement information for the Fund financial statements did not comply with accounting requirements.

Until the migratory strategy is established and final accounting systems selected, the time frames and costs are unknown for achieving accounting systems that comply with the Chief Financial Officers Act and Federal Financial Management Improvement Act of 1996 and for producing auditable financial statements.

Finding C. Implementation of Accounting Guidance

Accrual accounting guidance was not followed with regard to Contingent Liabilities, service costs to customers, and the accrual of sick leave for employee expense. The reported Contingent Liability should not have been posted in FY 1996. The unbilled FY 1996 service costs to customers for which reimbursement was not expected should have been expensed in FY 1996. Accrued sick leave for employees should not be expensed until it has been used. By not following guidance in these areas, the net effects on the Consolidated Statements of Operations and Changes in Net Position are a $3.5 million overstatement of FY 1997 Cost of Goods Sold expense and a $31.8 million overstatement of FY 1996 Cost of Goods Sold expense. In addition, Contingent Liabilities and Accrued Annual Leave are overstated by $28.5 million and $6.8 million, respectively, on the Consolidated FY 1997 Statement of Financial Position.

Contingent Liability. A contingent liability was improperly posted in FY 1996 for the anticipated costs for the CISA to convert from the Defense Commercial Telecommunications Network to the Defense Information System Network; there was a corresponding debit to program expenses. Accounting guidance requires that the existence of a past event giving rise to a liability is essential to the proper recognition of contingent liability. However, no such events could be documented. As a result, expenses to convert to the Defense Information System Network that should have been posted in FY 1997 or later were posted in FY 1996. Specifically, expenses were overstated by $50.1 million in FY 1996 and understated by $21.6 million in FY 1997. Also the ending FY 1997 Contingent Liability balance reflected an overstatement of $28.5 million.

In FY 1996, Program Budget Decision 417 specified that DISA was to retain the $50.1 million in savings realized from the extension of the Defense Telecommunications Network contract from March 1996 to June 1997. DISA was to retain the savings rather than reduce the FY 1997 customer rates, in order to offset the transition costs of $78.6 million associated with network modernization and equipment investment. As of the end of FY 1996, none of the $50.1 million was spent or obligated. Because of disbursements in FY 1997, the ending FY 1997 Contingent Liability balance was reduced to $28.5 million. As of the end of FY 1997, no justifying past events or obligations against the remaining Contingent Liability balance were documented.

Liabilities are described in the DoD Regulation 7000.14-R, volume 1, chapter 3, under Key Accounting Requirement Number 5, "Accrual Accounting," May 1993, which specifies: "When liabilities are incurred as work is performed rather than when deliveries are made, accruals must be recorded from performance reports for the affected accounting period." Contingent liabilities are discussed in the Federal Accounting Standards Advisory Board Original Statements," volume 1, "Statements of Federal Financial Accounting Concepts and Standards," No. 5, "Accounting for

Liabilities of the Federal Government," December 20, 1995: "Contingencies should be recognized as a liability when a past transaction or event has occurred, a future outflow or other sacrifice of resources is probable, and the related future outflow or sacrifice of resources is measurable."

Work in Process. Although there was no likelihood the DMCs would obtain additional revenue to recover unbilled service costs of $18.3 million, the costs were carried as Work in Process from FY 1996 into FY 1997 before they were written off. The unbilled service costs in excess of expected reimbursements were carried forward because Fund managers continued to believe that additional revenues could be provided. Accrual accounting guidance indicating that the costs of services provided to customers should be expensed when the costs were incurred or the services were provided was not followed. As a result, Cost of Goods Sold expenses were overstated in FY 1997 and understated in FY 1996 by at least $18.3 million.

The FY 1996 DMCs Working Capital Fund Statement of Financial Position had an ending balance of $21.8 million in Work in Process. Note No. 9 in the FY 1996 Notes to the Consolidated Principal Statements specified "It is anticipated that the DoD Comptroller will direct a write-off of all but $3.5 million of the Work in Process." The only revenue received in FY 1997 with regard to the Work in Process balance from FY 1996 was, as expected, the amount associated with the $3.5 million in service costs. The entire $21.8 million Work in Process balance from FY 1996 was written off in FY 1997.

Accrual accounting guidance for expenses in DoD Regulation 7000.14-R, volume 4, "Accounting Policy and Procedures," chapter 16, "Revenues, Expenses, Gains, and Losses," January 1995, provides that "Expenses and losses are the use of resources during an accounting period in carrying out DoD's mission. These can result from rendering services, delivering or producing goods, or carrying out other activities."

Accrual of Sick Leave. Accrued sick leave for CISA employees was included in the Annual Accrued Leave account and expensed through the Cost of Goods Sold account. In accruing sick leave on the financial statements, Fund managers did not follow the most current accounting guidance. As a result, the Cost of Goods Sold expenses were overstated by $6.8 million.

Accounting guidance at DoD Regulation 7000.14-R, volume 6, chapter 6, Appendix G, indicates "Sick and other types of nonvested leave are expensed as taken."

Conclusions. The accounting guidance was not followed in each of the above areas. Recognizing a Contingent Liability in the circumstances described was not justified during either FY 1996 or FY 1997. The unbilled service costs in excess of expected reimbursements carried in Work in Process from FY 1996 to FY 1997 should have been expensed in FY 1996. Sick leave should be expensed as taken.

Correcting Contingent Liability balances on the FY 1997 CISA WCF and DISA Defense-Wide WCF Financial Statements requires adjustments to reflect an increase to Cost of Goods of $21.6 million, a $28.5 million reduction to the Contingent Liability balance, and a prior period adjustment to reduce expenses

by $50.1 million. Correcting Work in Process balances on the FY 1997 DMCs and DISA Defense-Wide WCF Financial Statements requires an $18.3 million reduction in the Cost of Goods Sold and a prior period adjustment to increase expenses by $18.3 million. Correcting Accrued Annual Leave balances on the FY 1997 CISA and DISA Defense-Wide WCF Statements requires a reduction of $6.8 million in the Cost of Goods Sold also in the Accrued Annual Leave balance.

Recommendations for Corrective Action

C. We recommend that the Director, Defense Information Systems Agency:

1. Implement accounting guidance with regard to contingent liabilities, service costs, and accrual of sick leave expenses.

2.a. Correct the FY 1997 Defense Information Systems Agency Defense-Wide Working Capital Fund Financial Statements to reflect a reduction to Cost of Goods Sold of $3.5 million, a $28.5 million reduction to the Contingent Liability balance, a $6.8 million reduction to the Accrued Annual Leave balance, and a prior period adjustment to reduce expenses by $31.8 million.

b. Correct the FY 1997 Communications Information Services Activity Financial Statements to reflect an increase to the Cost of Goods Sold of $14.8 million, a $28.5 million reduction to the Contingent Liability balance, a $6.8 million reduction to the Accrued Annual Leave balance, and a prior period adjustment to reduce expenses by $50.1 million.

c. Correct the FY 1997 Defense Megacenters Working Capital Fund Financial Statements to reflect a reduction to the Cost of Goods Sold of $18.3 million, and a prior period adjustment to increase expenses by $18.3 million.

Management Comments Required

The Defense Information Systems Agency did not comment on a draft of this report. We request the agency to provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope

Statements Reviewed. We audited the Defense Information Systems Agency Working Capital Fund (the Fund) Financial Statements for the year ending September 30, 1997. The financial statements included the Statement of Financial Position, the Statement of Operations and Changes in Net Position, and the Statement of Cash Flows. Also included were the Footnotes and the Overview to the Principal Statements. Except for the Overview, the Defense-wide statements and accompanying data were consolidations of data also presented for each of two DISA WCF subgroups, the DMCs and the CISA. We received the financial statements and Footnotes on December 23, 1997, the Overview on December 31, 1997, and the program performance data on January 9, 1998.

Auditing Standards. We conducted our financial audit in accordance with generally accepted auditing standards issued by the Comptroller General of the United States as implemented by the IG, DoD, and OMB Bulletin No. 93-06, as amended by OMB Bulletin No. 97-01. Those standards require financial statements to be free of material misstatements. We relied on the guidelines suggested by the General Accounting Office and on our professional judgment in assessing the materiality of matters impacting the fair presentation of the financial statements and related internal control weaknesses.

Accounting Principles. Accounting principles and standards for the Federal Government are under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to three officials for approval. Those three officials are the Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States. Specific standards agreed on by those officials are issued by the Director, OMB, and the Comptroller General.

To date, seven accounting standards and two accounting concepts have been published in final form. Another accounting standard (No. 8) has been approved by the Federal Accounting Standards Advisory Board, but it must be reviewed by Congress before it is issued by OMB. In addition, the Federal Accounting Standards Advisory Board issued an exposure draft, "Amendments to Accounting for Property, Plant, and Equipment," February 13, 1998, proposing amendments to Standards No. 6 and No. 8. These standards and concepts constitute generally accepted accounting principles for the Federal Government. OMB Bulletin No. 94-01, as amended by OMB Bulletin No. 97-01, incorporates these standards and concepts and should be used by Federal agencies to prepare their financial statements. The following table lists the "Statements of Federal Financial Accounting Standards and Concepts."

Statements of Federal Financial Accounting Standards and Concepts

Accounting Standards and Concepts	Title	Status	Fiscal Year Effective
Standard No. 1	Accounting for Selected Assets and Liabilities, March 30, 1993	Final	1994
Standard No. 2	Accounting for Direct Loans and Loan Guarantees, August 23, 1993	Final	1994
Standard No. 3	Accounting for Inventory and Related Property, October 27, 1993	Final	1994
Standard No. 4	Managerial Cost Accounting Concepts and Standards, July 31, 1995	Final	1998
Standard No. 5	Accounting for Liabilities of the Federal Government, December 20, 1995	Final	1997
Standard No. 6	Accounting for Property, Plant, and Equipment, November 30, 1995	Final*	1998
Standard No. 7	Accounting for Revenue and Other Financing Sources, May 10, 1996	Final	1998
Standard No. 8	Supplementary Stewardship Reporting, June 11, 1996	Approved*	
Concept No. 1	Objectives of Federal Financial Reporting, September 2, 1993	Final	
Concept No. 2	Entity and Display, June 6, 1995	Final	

*The Financial Accounting Standards Advisory Board has issued an exposure draft, "Amendments to Accounting For Property, Plant, and Equipment," February 13, 1998. The exposure draft contains proposed amendments to Standards No. 6 and No. 8.

Through FY 1997, agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 94-01, as amended by OMB Bulletin No. 97-01. A summary of the FY 1997 hierarchy follows:

- standards agreed to and published by the Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States;
- requirements for form and content in OMB Bulletin No. 94-01, as amended by OMB Bulletin No. 97-01;

- accounting standards contained in agency accounting policy, procedures, or other guidance as of March 29, 1991; and
- accounting principles published by other authoritative sources.

Overview and Performance Measures. We also reviewed the financial information in the Overview to the FY 1997 Fund's Financial Statements. We did not find any instances in which the information presented in the Overview was materially inconsistent with the information presented in the Principal Statements. The information has not been audited by us; accordingly, we are not expressing an opinion. The performance measure data was not reviewed.

Review of Internal Controls. An audit examines, on a test basis, evidence supporting the amounts and disclosures in financial statements, including the accompanying notes. An audit also assesses the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements. We reviewed internal controls related to the FY 1997 Fund's Financial Statements. For areas where internal controls were determined to be weak, we attempted to perform tests to determine the level of assurance that could be placed on these controls.

Our consideration of the internal controls would not necessarily disclose all matters in the internal controls that might be reportable conditions and would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

Review of Compliance With Laws and Regulations. Compliance with laws and regulations is the responsibility of the Fund managers. To obtain reasonable assurance that the Fund financial statements were free of material misstatements, we performed tests of compliance with laws and regulations that may directly affect the financial statements and other laws and regulations designated by the OMB and DoD. See Appendix E for a list of laws and regulations reviewed.

Methodology

Computer-Processed Data. To achieve the overall audit objective, we initially relied upon computer-processed data obtained from the Defense Property Accountability System and the Performance Asset Management system. The data was used as a basis for our sampling of the capital property inventory. We assessed the reliability of the computer-processed data by reviewing the general systems controls and by performing the inventory. The computer-processed information provided was found to be generally reliable.

Statistical Sampling Methodology. The Quantitative Methods Division, IG, DoD, developed the statistical sampling plan for this audit. That work included statistically selecting locations and inventory line items at each location. The audit universe consisted of all DISA Working Capital Fund capital property as of September 30, 1997. We followed the sampling plan while performing inventories. However, since the reasons underlying our disclaimer of opinion

existed independently of statistical projections of inventory results, we chose not to proceed with such projections. From the inventories we were able to determine the equipment quantities data were generally accurate for the items sampled.

Audit Period and Locations. We conducted this audit from May 1997 through April 1998 at various DISA operating and equipment locations and at the Defense Finance and Accounting Service locations in Cleveland and Pensacola.

Representation Letters. We received a management representation letter from the Director, DISA, and the Chief Financial Officer, DISA. The letter acknowledged that they could not provide assurances regarding the accuracy of the Accounts Receivable and Accounts Payable balances shown in the financial statements. See Appendix D for the management representation letter.

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

Management Control Program

DoD Directive 5010.38, and DoD Instruction 5010.40, require DoD organizations to implement a comprehensive system of internal controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the Fund's internal controls as they relate to the Fund's financial statements. Specifically, we reviewed Fund management controls over recording, accounting, and reporting financial information resulting from Fund operations during FY 1997.

Adequacy of Management Controls. The Fund's internal controls were generally adequate; however, material weaknesses were identified in the processing and reconciling of undistributed collections and disbursements (and their effects on Accounts Receivable and Accounts Payable), and also for Property, Plant, and Equipment, along with significant deficiencies with the accounting systems in those areas. The officials responsible for management controls will receive copies of the report. General Accounting Office Report No. AIMD-97-150 (OSD Case 1444) discussed interface problems in the DISA implementation of the Defense Property Accountability System.

Adequacy of Management's Self-Evaluation. The Annual Statements of Assurance of DFAS identified weaknesses in undistributed and unmatched cross-disbursing and interfund transactions and in accounting and reporting for the Defense Working Capital Funds. The Annual Statements of Assurance of the DISA referenced the General Accounting Office report mentioned above but did not refer to the lack of reconciliations or audit trails involved with the Defense Property Accountability System implementation.

Appendix B. Prior Audit Reports

General Accounting Office Report No. AIMD 97-150 (OSD Case No. 1444), "DoD's Approach to Financial Control Over Property Needs Structure," September 30, 1997, addresses whether DPAS was designed to meet functional accounting requirements for general property, plant, and equipment. The report states that DPAS can provide financial control and generate information to account for most general property, plant, and equipment. However, the report states that DoD did not define the roles, responsibilities, and relationships among the various DoD entities involved, including the identification of needed manual and automated interfaces and related controls. As a result, the implementation of DPAS did not ensure financial control and accurate reporting of general property, plant, and equipment because DPAS incorrectly interfaced with the accounting system. The report recommended the development of a concept of operations and a detailed DPAS implementation. In addition, the report recommended that the transactions produced by DPAS for updating the general ledger should reflect the posting logic for both debit and credit and the expansion of DPAS functionality to ensure that transactions meet all current and pending requirements related to property found in Federal accounting standards and DoD financial management regulations. To resolve implementation problems specific to DISA, the report recommended that a request be submitted to the DPAS project office to include appropriate additional transaction edits required by DISA for general ledger processing, the interface program be corrected, and procedures be finalized for reconciliation of DISA general ledger accounts for property records, including provisions to ensure that reconciliations are timely and general ledger control is maintained over general property, plant, and equipment. The Acting Under Secretary of Defense (Comptroller) generally concurred with the report findings and recommendations.

Inspector General, DoD, Report No. 98-135, "Implementation of the Defense Property Accountability System," May 18, 1998, states that the implementation of DPAS does not remedy the systemic weakness, "Unreliable Financial Reporting of Personal and Real Property," reported in the DoD Annual Statement of Assurance. The audit was unable to review DPAS capabilities to support auditable financial statements in compliance with the Chief Financial Officers Act and the Government Management Reform Act of 1994 because DoD had not clarified the scope of the system or addressed the integration to related financial systems. The report recommended that the Under Secretary of Defense for Acquisition and Technology in coordination with the Assistant Secretary of Defense (Command, Control, Communications and Intelligence) revise the implementation strategy for DPAS and refer the system to the Major Automated Information System Review Council as a special interest program. In addition, the report recommended that the Under Secretary of Defense for Acquisition and Technology establish an Integrated Product Team consisting of the Under Secretary of Defense (Comptroller), Military Departments, Defense Finance and Accounting Service, and Defense Logistics Agency for continued program management. The report also recommended that the Under Secretary of Defense (Comptroller) continue to report as a systemic weakness the unreliable financial reporting of personal and real property. Management agreed to clarify the scope of the system and continue to report a systemic weakness. The remaining issues will be mediated.

Inspector General, DoD, Report No. 97-006, "Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund in FY 1995," October 15, 1996, identifies significant accounting and management control deficiencies that prevented the timely development and reliable presentation of the DBOF financial statements. The report listed DBOF accounting systems as a major category of management control structures. Significant management control weaknesses existed in the DBOF accounting systems. The report concluded that the management control structure of existing accounting systems was so weak that reliable and auditable financial statements probably would not be available until at least FY 2002, after DBOF has converted from legacy systems to interim migratory systems. DoD senior management acknowledged the presence of severe control flaws in the DBOF accounting systems and took action to upgrade the systems and eliminate the weaknesses. The report contained no recommendations because numerous recommendations addressing these issues were made in previous audit reports.

Inspector General, DoD, Report No. 96-155, "The Defense Information Systems Agency General Ledger Military Equipment Account," June 10, 1996, analyzes the DISA Appropriated Equipment in Use account. The report scope did not include the DISA Working Capital Fund, real property or property accountability; however, it does state that there were major differences between the general ledger account and the DPAS property records for several sample items. Since DPAS was recently implemented at DISA, the report states that further reconciliations between the general ledger account and the property accountability record were not performed. The report also notes that one of the sample transactions was recorded on both the DISA-appropriated and DISA Working Capital Fund general ledgers. This issue was corrected before the report was issued; therefore, no recommendation was made.

Inspector General, DoD, Report No. 96-001, "Defense Business Operations Fund-Defense Information Services Organization Financial Statement for FY 1994," October 4, 1995. The audit objective was to determine whether the DBOF-DISO Property, Plant, and Equipment balances reported on the Statement of Financial Position for FY 1994 were presented fairly in accordance with generally accepted accounting principles. The audit found that DISA-Western Hemisphere (DISA WESTHEM) did not prepare and present FY 1994 financial statements for the DBOF-DISO that were accurate or in compliance with laws and regulations. Specifically, DISA WESTHEM did not establish property records that showed the acquisition value of capital assets, verify that Defense Megacenters and legacy sites implemented procedures to reconcile capital asset data with property records, use one standard property accounting system at the DMCs and legacy sites to record the inventory of Property, Plant, and Equipment. The audit also found that DISA WESTHEM did not report depreciation expense and related footnotes properly for the FY 1994 financial statements for DBOF-DISO. The report recommended establishing procedures and controls for the timely and accurate recording of capital assets and for reconciling related financial accounts to the property book system. Additional recommendations were made to provide more accounting training for

accountable property officers, to implement the DoD standard property accounting system at DISA WESTHEM, and to correct the depreciation expense accounting entry. DISA concurred with all recommendations.

Inspector General, DoD Report No. 95-280, "Management Control Program at Defense Information Systems Agency, Western Hemisphere," July 26, 1995, states that DISA and DFAS did not adequately review accounting system controls. As a result, DFAS and DISA annual reviews of accounting systems cannot be relied on to verify the adequacy of accounting system controls needed to ensure the accuracy, completeness, and reliability of DISA financial statements for FY 1994. The audit recommended that DFAS and DISA establish a memorandum of agreement to coordinate annual reviews of accounting system controls to include specifying responsibilities for the DFAS system manager and DISA system user; train system managers and users in performing annual reviews of accounting system controls; and document accounting system controls and related control testing during the reviews. Both DFAS and DISA generally concurred with the finding and recommendations, except for the recommendation to establish a memorandum of agreement to coordinate annual reviews of accounting system controls. DFAS responded that existing guidance already required that system managers and users participate in annual reviews, but agreed to reinforce existing guidance by including selective users, such as DISA, in each appropriate review.

Inspector General, DoD, Report No. 93-153, "Defense Business Operations Fund-Communication Information Services Activity Financial Statements for FY 1992," August 6, 1993, states that internal control weaknesses for transactions and events had a direct and material effect on the Principal Statements. The audit objective was to determine whether the FY 1992 financial statements were presented fairly in accordance with generally accepted accounting principles for Federal agencies. The audit opinion was that, except for the effects of scope limitations and noncompliance with laws and regulations discussed in the report, the Principal Statements presented fairly, in all material respects, the financial position in accordance with OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements." However, internal controls did not ensure the accuracy and proper classification of accounts payable. The DBOF-CISA Comptroller stated that internal control techniques were implemented to correct the weaknesses. The audit report did not make any recommendations.

Appendix C. Principal Statements, Footnotes, and Audit Opinion

This appendix (a total of 36 pages) consists of excerpts from the "Defense Information Systems Agency Working Capital Fund Chief Financial Officer Annual Financial Statement FY 1997," February 27, 1998. These pages include the Consolidated Principal Statements, Footnotes to the Principal Statements, and the Audit Opinion. A complete set of the "Defense Information Systems Agency Working Capital Fund Chief Financial Officer Annual Financial Statement FY 1997" is available at the following internet address: http://www.dtic.mil/comptroller/97afs/.

DEFENSE INFORMATION SYSTEMS AGENCY

DEFENSE- WIDE WORKING CAPITAL FUND

CONSOLIDATED PRINCIPAL STATEMENTS

Department of Defense
Defense Information Systems Agency - Consolidated Statements
Statement of Financial Position
As of September 30, 1997
(Thousands)

ASSETS	1997	1996
1. Entity Assets:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Fund Balance with Treasury (Note 2)	$180,855	$144,658
(2) Investments, Net (Note 4)	0	0
(3) Accounts Receivable, Net (Note 5)	432,880	401,924
(4) Interest Receivable	0	0
(5) Advances and Prepayments	80	80
(6) Other Federal (Intragovernmental) (Note 6)	9	2
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Investments (Note 4)	0	0
(2) Accounts Receivable, Net (Note 5)	2,698	16,804
(3) Credit Program Receivables/ Related Foreclosed Property, Net (Note 7)	0	0
(4) Interest Receivable, Net	0	0
(5) Advances and Prepayments	1,378	5,960
(6) Other Non-Federal (Governmental) (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	0	0
d. Inventory, Net (Note 8)	0	0
e. Work in Process (Note 9)	34,739	21,824
f. Operating Materials/Supplies, Net (Note 10)	707	614
g. Stockpile Materials, Net (Note 11)	0	0
h. Seized Property (Note 12)	0	0
i. Forfeited Property, Net (Note 13)	0	0
j. Goods Held Under Price Support and Stabilization Programs, Net (Note 14)	0	0
k. Property, Plant and Equipment, Net (Note 15)	226,699	305,230
l. War Reserves	0	0
m. Other Entity Assets	0	0
n. Total Entity Assets	$880,045	$897,096
2. Non-Entity Assets:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Fund Balance with Treasury (Note 2)	$0	$0
(2) Accounts Receivable, Net (Note 5)	0	0
(3) Interest Receivable, Net	0	0
(4) Other (Note 6)	0	0

The accompanying notes are an integral part of these statements.

Department of Defense
Defense Information Systems Agency - Consolidated Statements
Statement of Financial Position
As of September 30, 1997
(Thousands)

ASSETS, Continued	**1997**	**1996**
2. Non-Entity Assets:		
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Receivable, Net (Note 5)	$0	$0
(2) Interest Receivable, Net	0	0
(3) Other (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	0	0
d. Other Non-Entity Assets	0	0
e. Total Non-Entity Assets	$0	$0
3. Total Assets	$880,045	$897,096
LIABILITIES		
4. Liabilities Covered by Budgetary Resources:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$19,264	$188,889
(2) Interest Payable	0	0
(3) Debt (Note 16)	0	0
(4) Other Federal (Intragovernmental) Liabilities (Note 17)	21	18
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	444,392	160,338
(2) Accrued Payroll and Benefits		
(a) Salaries and Wages	10,200	113,230
(b) Annual Accrued Leave	25,023	23,048
(c) Severance Pay and Separation Allowance	0	0
(3) Interest Payable	0	1
(4) Liabilities for Loan Guarantees (Note 7)	0	0
(5) Lease Liabilities (Note 18)	0	3,622
(6) Pensions and Other Actuarial Liabilities (Note 19)	0	0
(7) Other Non-Federal (Governmental) Liabilities (Note 17)	28,508	50,100
c. Total Liabilities Covered by Budgetary Resources:	$527,408	$539,246

The accompanying notes are an integral part of these statements.

Department of Defense
Defense Information Systems Agency - Consolidated Statements
Statement of Financial Position
As of September 30, 1997
(Thousands)

LIABILITIES, Continued	**1997**	**1996**
5. Liabilities Not Covered by Budgetary Resources:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$0	$0
(2) Debt (Note 16)	0	0
(3) Other Federal (Intragovernmental) Liabilities (Note 17)	0	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	0	0
(2) Debt (Note 16)	0	0
(3) Lease Liabilities (Note 18)	0	0
(4) Pensions and Other Actuarial Liabilities (Note 19)	18,040	0
(5) Other Non-Federal (Governmental) Liabilities (Note 17)	0	0
c. Total Liabilities Not Covered by Budgetary Resources	$18,040	$0
6. Total Liabilities	$545,448	$539,246
NET POSITION (Note 20)		
7. Balances:		
a. Unexpended Appropriations	$0	$7,455
b. Invested Capital	412,479	417,985
c. Cumulative Results of Operations	(59,842)	(67,590)
d. Other	0	0
e. Future Funding Requirements	(18,040)	0
f. Total Net Position	$334,597	$357,850
8. Total Liabilities and Net Position	$880,045	$897,096

The accompanying notes are an integral part of these statements.

Department of Defense
Defense Information Systems Agency - Consolidated Statements
Statement of Operations and Changes in Net Position
For the Period Ended September 30, 1997
(Thousands)

	1997	1996
REVENUES AND FINANCING SOURCES		
1. Appropriated Capital Used	$31,906	$30,396
2. Revenues from Sales of Goods and Services		
a. To the Public	412	170,816
b. Intragovernmental	2,449,349	2,587,493
3. Interest and Penalties, Non-Federal	0	0
4. Interest, Federal	0	0
5. Taxes (Note 21)	0	0
6. Other Revenues and Financing Sources (Note 22)	16,288	7,237
7. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies	0	0
8. Total Revenues and Financing Sources	$2,497,955	$2,795,942
EXPENSES		
9. Program or Operating Expenses (Note 23)	$0	$0
10. Cost of Goods Sold (Note 24)		
a. To the Public	404	136,231
b. Intragovernmental	2,329,091	2,512,373
11. Depreciation and Amortization	136,646	143,767
12. Bad Debts and Writeoffs	0	81
13. Interest		
a. Federal Financing Bank/Treasury Borrowing	0	0
b. Federal Securities	0	0
c. Other	0	0
14. Other Expenses (Note 25)	13,869	4,286
15. Total Expenses	$2,480,010	$2,796,738
16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary Items	$17,945	($796)
17. Plus (Minus) Extraordinary Items (Note 26)	0	0
18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	$17,945	($796)

The accompanying notes are an integral part of these statements.

Department of Defense
Defense Information Systems Agency - Consolidated Statements
Statement of Operations and Changes in Net Position
For the Period Ended September 30, 1997
(Thousands)

	1997	1996
EXPENSES, Continued		
19. Net Position, Beginning Balance, as Previously Stated	$357,850	$347,304
20. Adjustments (Note 27)	(10,198)	62,090
21. Net Position, Beginning Balance, as Restated	$347,652	$409,394
22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	17,945	(796)
23. Plus (Minus) Non Operating Changes (Note 28)	(31,000)	(50,748)
24. Net Position, Ending Balance	$334,597	$357,850

The accompanying notes are an integral part of these statements.

Department of Defense
Defense Information Systems Agency - Consolidated Statements
Statement of Cash Flows
For the Period Ended September 30, 1997
(Thousands)

	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES		
1. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	$17,945	($796)
Adjustments Affecting Cash Flow:		
2. Appropriated Capital Used	(31,906)	30,396
3. Decrease (Increase) in Accounts Receivable	(33,583)	18,628
4. Decrease (Increase) in Other Assets	(8,432)	(19,859)
5. Increase (Decrease) in Accounts Payable	131,161	(72,863)
6. Increase (Decrease) in Other Liabilities	(126,267)	137,285
7. Depreciation and Amortization	136,646	143,767
8. Other Unfunded Expenses	31,906	(30,396)
9. Other Adjustments	(12,338)	14,832
10. Total Adjustments	$87,187	$221,790
11. Net Cash Provided (Used) by Operating Activities	$105,132	$220,994
CASH FLOWS FROM INVESTING ACTIVITIES		
12. Sale of Property, Plant and Equipment	$0	$132,497
13. Purchase of Property, Plant and Equipment	(62,502)	(250,011)
14. Sale of Securities	0	0
15. Purchase of Securities	0	0
16. Collection of Loans Receivable	0	0
17. Creation of Loans Receivable	0	0
18. Other Investing Cash Provided (Used)	0	0
19. Net Cash Provided (Used) by Investing Activities	($62,502)	($117,514)
CASH FLOWS FROM FINANCING ACTIVITIES		
20. Appropriations (Current Warrants)	$0	$0
21. Add:		
a. Restorations	0	0
b. Transfers of Cash from Others	0	35,501
22. Deduct:		
a. Withdrawals	0	0
b. Transfers of Cash to Others	6,433	0
23. Net Appropriations	($6,433)	$35,501

The accompanying notes are an integral part of these statements.

Department of Defense
Defense Information Systems Agency - Consolidated Statements
Statement of Cash Flows
For the Period Ended September 30, 1997
(Thousands)

	1997	1996
CASH FLOWS FROM FINANCING ACTIVITIES, Continued		
24. Borrowing from the Public	$0	$0
25. Repayments on Loans to the Public	0	0
26. Borrowing from the Treasury and the Federal Financing Bank	0	0
27. Repayments on Loans from the Treasury and the Federal Financing Bank	0	0
28. Other Borrowings and Repayments	0	0
29. Net Cash Provided (Used) by Financing Activities	($6,433)	$35,501
30. Net Cash Provided (Used) by Operating, Investing and Financing Activities	$36,197	$138,981
31. Fund Balance with Treasury, Cash, and Foreign Currency, Beginning	144,658	5,677
32. Fund Balance with Treasury, Cash, and Foreign Currency, Ending	$180,855	$144,658

Supplemental Disclosure of Cash Flow Information:	1997	1996
33. Total Interest Paid	$0	$0

Supplemental Schedule of Financing and Investing Activity:	1997	1996
34. Property and Equipment Acquired Under Capital Lease Obligations	$0	$0
35. Property Acquired Under Long-Term Financing Arrangements	$0	$0
36. Other Exchanges of Non-cash Assets or Liabilities	$0	$0

The accompanying notes are an integral part of these statements.

The accompanying notes are an integral part of these statements.

DEFENSE INFORMATION SYSTEMS AGENCY

DEFENSE-WIDE WORKING CAPITAL FUND

FOOTNOTES TO THE CONSOLIDATED PRINCIPAL STATEMENTS

NOTES TO THE FISCAL YEAR 1997 PRINCIPAL STATEMENTS DEFENSE-WIDE WORKING CAPITAL FUND DEFENSE INFORMATION SYSTEMS AGENCY-CONSOLIDATED PERIOD ENDING 30 SEPTEMBER 1997

Note 1. Summary of Significant Accounting Policies:

A. Basis of Presentation:

These financial statements were prepared to report the financial position and results of operations of the Department of Defense (DOD), Defense-Wide Working Capital Fund (DWCF), Defense Information Systems Agency (DISA), Communications Information Services Activity (CISA) and Defense Megacenters (DMCs), as required by the Chief Financial Officers (CFO) Act of 1990 and other applicable legislation. The statements were prepared from the books and records of the activities in accordance with DOD guidance on the form and content of financial statements as adopted from OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," and subsequent issues. These statements are prepared net of intra-agency eliminations (i.e., CISA to DMCs).

The Defense Finance and Accounting Service (DFAS)-Cleveland Center prepared these statements from information contained in DMC trial balances aggregated on the DFAS Central Data Base System and from information derived from the Finance and Accounting Management Information System (FAMIS) which supports the CISA. Amounts presented are rounded to the nearest thousand.

B. Reporting Entity:

Respective DISA-DWCF entities provide telecommunication and information systems, and data processing services to DOD and other federal government customers under a revolving fund concept. In FY 1996, these funds were consolidated into the DWCF and represented by fund symbol 97X4930.

C. Budgets and Budgetary Accounting:

The DISA-DWCF is financed on a reimbursable basis designed to provide an effective means of financing, budgeting, accounting for and controlling resources, as well as the costs of providing products and services used to support both peace and war time operations.

DOD expanded the use of business-like financial management practices through the establishment of the Defense Business Operations Fund (DBOF) on October 1, 1991. The DBOF employed revolving fund principles previously used by industrial and commercial-type activities.

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On December 11, 1996, DOD further refined the concept by eliminating the single fund and established four separate working capital funds. The working capital funds operate using financial principles which provide improved cost visibility and accountability to enhance business and cash management, as well as improve the decision making process. In FY 1997, DISA-DWCF activities recorded an operating gain of $17,945 thousand.

SALES, COST OF SALES AND EXPENSES
AND NET OPERATING RESULTS BY ACTIVITY
($ In thousands)

Activity	Sales	Cost of Sales and Expenses	Net Operating Results
CISA	$1,996,114	$2,014,644	($18,530)
DMC	681,914	645,439	36,475
TOTAL	$2,678,028	$2,660,083	$17,945

D. Basis of Accounting:

Transactions are recorded on a budgetary and accrual accounting basis. Accrual accounting recognizes revenue when earned and recognizes expenses when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting, through unique general ledger accounts, facilitates compliance with legal constraints and controls the use of federal funds.

E. Revenues and Other Financing Sources:

Reimbursements are recognized as revenue when earned. This revenue is used to offset the cost of products and services rendered, including an amount to recover the cost of overhead. The amount of revenue recognized cannot exceed the amount specified in orders from customers.

F. Accounting for Intra-Governmental Activities:

These statements are prepared net of intra-agency eliminations.

G. Funds with the U.S. Treasury and Cash:

Because cash control for DISA-DWCF entities is maintained by the Defense Logistics Agency (for all defense agencies), DMC collection and disbursement balances are transferred from the activity level to the defense agency corporate level at the beginning of each fiscal year for financial statement preparation purposes. As a result, financial statements at the activity level

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do not reflect cumulative cash balances. CISA's financial statements do not reflect the close out of prior year collections and disbursements. Therefore, they contain cumulative cash balances. Inconsistency between DMC and CISA cash reporting is under review.

H. Foreign Currency:

Not Applicable.

I. Accounts Receivable:

Accounts receivable consist of amounts owed to DISA-DWCF activities by other DOD and non-DOD agencies the majority of which are due from non-DOD agencies. An ongoing review of outstanding receivables does not support recording an allowance for uncollectible accounts.

J. Loans Receivable:

Not Applicable.

K. Inventories:

The DMCs are primarily service providers. Therefore, operating supplies are not a significant cost element.

L. Investments in U. S. Government Securities:

Not Applicable.

M. Property and Equipment:

Telecommunication and data processing equipment and software are stated at cost, less accumulated depreciation computed on a straight-line method over a five year period that begins when the equipment becomes operational. Routine maintenance is expensed when incurred.

N. Prepaid and Deferred Charges:

Not Applicable.

O. Leases:

Operating leases exist in both the CISA and DMCs and are expensed when incurred. There are no capital leases related to DISA-DWCF operations.

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P. Contingencies:

For the CISA, a contingent liability (Note 17) in the amount of $28,508 thousand represents anticipated future costs of the Defense Information Systems Network (DISN) transition. Telecommunications customers of the Defense Communication System (DCS) programs will migrate to the DISN as it is brought on line.

Q. Accrued Leave:

The value of annual leave is increased as earned and reduced as leave is taken. Sick leave is expensed as taken. For the DMCs, sick leave balances at year end are closed out. For the CISA, accrued sick leave is not zeroed out for the fiscal year. This accounting treatment is being reviewed.

R. Equity:

CISA equity (Note 20) shows a negative position of $58,203 thousand. Major contributing factors were: operating loss of $18,530 thousand; prior period adjustment of $8,255 thousand to reduce fixed assets that were inappropriately coded as capitalized equipment; and other prior period adjustments (Note 27), which resulted in a total equity reduction of $10,123 thousand. DMC equity is shown as $410,840 thousand in Note 20. This includes the effect of a positive $17,706 thousand in "Cumulative Results of Operations".

S. Aircraft/Ship Crashes:

Not Applicable.

T. Treaties for Use of Foreign Bases:

Not Applicable.

U. Comparative Data:

The Principal Statements present comparative data for FY 1997 and FY 1996.

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Note 2. Fund Balances with Treasury (in thousands):

A. Fund and Account Balances:

	Entity Assets				
	Trust Funds	Revolving Funds	Appro-priated Funds	Other Fund Types	Total
Unobligated Balance Available:					
Available	$0	$0	$0	$0	$0
Restricted					
Reserve For Anticipated Resources					
Obligated (but not expensed)		$92,794			92,794
Unfunded Contract Authority					
Unused Borrowing Authority					
Working Capital Fund Balances		88,061			88,061
Treasury Balance	$0	$180,855	$0	$0	$180,855

B. Other Information: None

Note 3. Cash, Foreign Currency and Other Monetary Assets (in thousands):

Not applicable.

Note 4. Investments, Net (in thousands): Not applicable.

Note 5. Accounts Receivable, Net (in thousands):

	(1) Gross Amount Due	(2) Allowance For Estimated Uncollectibles	(3) Allowance Method Used	(4) Net Amount Due
A. Entity Receivables:				
Intragovernmental	$432,880	$0		$432,880
Governmental	2,698			2,698
B. Non-Entity Receivables:				
Intragovernmental	$0	$0		$0
Governmental				

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C. Other Information: DFAS-CL: Entity Receivables, Intragovernmental, include Intrafund Elimination of ($16,733).

Note 6. Other Federal (Intragovernmental) and Non-Federal (Governmental) Assets (in thousands):

A. Other Entity Assets

1. Intergovernmental

Advance to US Printing Office for printing service	$9
Total	$9

2. Governmental

B. Other Information: None

Note 7. Loans and Loan Guarantees, Non-Federal Borrowers (in thousands):
Not applicable.

Note 8. Inventory, Net (in thousands): Not applicable.

Note 9. Work in Process (in thousands):

	(1) Work In Process Amount	(2) Valuation Method
A. Work in Process:		
In House	$34,739	Actual Cost
Total	$34,739	

B. Other Information: Work in Process (WIP) of $34,739 thousand includes accrued costs identifiable to a customer but unbillable because of insufficient funding. Of this amount, $32,299 thousand is attributable to DFAS. Discussions with DFAS to resolve this issue are ongoing. The remaining $2,440 thousand is spread across the spectrum of military departments/defense agencies and will either be collected as revenue or recognized as a loss during FY 1998 if deemed uncollectible.

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Note 10. Operating Materials and Supplies (OM&S), Net (in thousands):

	(1) OM&S Amount	(2) Allowance For Losses	(3) OM&S, Net	(4) Valuation Method
A. OM&S Categories:				
1. Held for Use	$707	$0	$707	Actual Cost
2. Held in Reserve for Future Use				
3. Excess, Obsolete and Unserviceable				
Total	$707	$0	$707	

B. Restrictions on operating materials and supplies: None

C. Other Information: None

Note 11. Stockpile Materials, Net (in thousands): Not applicable.

Note 12. Seized Property (in thousands): Not applicable.

Note 13. Forfeited Property, Net (in thousands): Not applicable.

Note 14. Goods Held Under Price Support and Stabilization Programs, Net (in thousands):
Not applicable.

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Note 15. Property, Plant and Equipment, Net (in thousands):

Classes of Fixed Assets	(1) Depreciation Method	(2) Service Life	(3) Acquisition Value	(4) Accumulated Depreciation	(5) Net Book Value
A. Land			$0	$0	$0
B. Structures, Facilities, & Leasehold Improvements					
C. Military Equipment					
D. ADP Software	SL	1-5	72,512	49,528	22,984
E. Equipment	SL	1-5	851.487	681,087	170,400
F. Assets Under Capital Lease					
G. Other	SL	1-5	10,232	528	9,704
H. Natural Resources					
I. Construction-in-Progress			23,611		23,611
Total			$957,842	$731,143	$226,699

J. Other Information: For the CISA, 'Other' represents funds expended for capital assets which are not presently installed or operational in any DCS program. Depreciation is recorded for these assets when they are installed and operational.

Depreciation expenses occur over a predetermined period (see below). Periodicity is as follows: equipment purchases other than ADPE, 10 years; general-purpose vehicles, ADPE and telecommunications hardware and software, 5 years; minor construction, 20 years. For equipment transferred into a business area, depreciation is based on the remaining book value. Depreciation of capital equipment is fully reflected in the operating costs and rates.

For the DMCs, in fourth quarter FY 1996, inventories were converted to the Defense Property Accounting System (DPAS). That conversion was audited and validated by the DISA Inspector General in their report "Audit of WESTHEM Proposed FYs 1992-1995 Depreciation Expense Adjustment," Final Report No. 97-A02, November 5, 1996. FY 1997 depreciation and capital accounting transaction and balance data was reconciled between DPAS and IFAS at year-end and were found to be in balance.

*Keys:

Depreciation Methods	Range of Service Life	
SL - Straight Line	1-5	1 to 5 years
DD - Double-Declining Balance	6-10	6 to 10 years
SY - Sum of the Years' Digits	11-20	11 to 20 years
IN - Interest (sinking fund)	>20	Over 20 years
PR - Production (activity or use method)		
OT - Other (describe)		

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Note 16. Debt (in thousands): Not applicable.

Note 17. Other Liabilities (in thousands):

A. Other Liabilities Covered by Budgetary Resources:

	Non-Current Liabilities	Current Liabilities	Total
1. Intragovernmental			
a. Advances-Government	$0	$21	$21
b. Advances-Loans			
c. Progress Payments-WIP-In-House			
d. Progress Payments-Direct Material			
e. Progress Payments-Other Government			
f. Military Labor			
g. Incomplete Voyage Revenue			
h. Undistributed Cash Disbursements			
i. Accrued Reserve Revenue			
j. Miscellaneous Other Liabilities			
Total	$0	$21	$21

	Non-Current Liabilities	Current Liabilities	Total
2. Governmental			
a. Advances-Other	$0	$0	$0
b. Accrued Expenses-Other			
c. Progress Payments-Contractor			
d. Miscellaneous Other Liabilities		28,508	28,508
e. Claims			
f. Undistributed Cash Disbursements			
Total	$0	$28,508	$28,508

B. Other Information: Governmental amount represents a contingent liability established for anticipated future costs of the DISN transition. Telecommunications customers of DCS programs will migrate to the DISN as it is brought on line.

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C. Other Liabilities Not Covered by Budgetary Resources:

	Non-Current Liabilities	Current Liabilities	Total
1. Intragovernmental			
a. Canceled Budget Authority	$0	$0	$0
b.			
c.			
Total	$0	$0	$0

	Non-Current Liabilities	Current Liabilities	Total
2. Governmental			
a. Canceled Budget Authority	$0	$0	$0
b.			
c.			
Total	$0	$0	$0

D. Other Information: Not applicable

Note 18. Leases (in thousands):

A. Entity As Lessee: Not applicable.

B. Entity As Lessor: Not applicable.

C. Other Information: Note 18 in the FY 1996 CFO financial statements showed lease data which was thought to be erroneous but was included until research could be completed. Results of that research found that DMCs have no capital lease liabilities - current or future. Necessary expense adjustments were made to the DMC accounts to properly clear the records.

CISA has operating leases for telecommunications circuitry on a month-to-month basis and software/hardware maintenance for current year from commercial providers. In FY 1997, costs related to operating leases are included in the cost of goods/services sold. Future payment calculation is not applicable.

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Note 19. Pensions and Other Actuarial Liabilities (in thousands):

A. Workers Compensation

DISA WCF	$18,040
Total	$18,040

B. Other Information: Future workers' compensation figures are provided by the Department of Labor. The liability for future workers' compensation (FWC) benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. The liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Consistent with past practice, these projected annual benefit payments have been discounted to present value using the Office of Management and Budget's, June 10, 1997 economic assumptions for 10-year Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

1997
6.24 % in year 1
5.82 % in year 2
5.60 % in year 3
5.45 % in year 4
5.40 % in year 5 and thereafter

Note 20. Net Position (in thousands):

	Revolving Funds	Trust Funds	Appropriated Funds	Total
A. Unexpended Appropriations:				
1. Unobligated,				
a. Available	$0	$0	$0	$0
b. Unavailable				
2. Undelivered Orders				
B. Invested Capital	412,479			412,479
C. Cumulative Results of Operations	(59,842)			(59,842)
D. Other				
E. Future Funding Requirements	(18,040)			(18,040)
F. Total	$334,597	$0	$0	$334,597

G. Other Information: None

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Note 21. Taxes (in thousands): Not applicable.

Note 22. Other Revenues and Financing Sources (in thousands):

	1997	1996
A. Other Revenues and Financing Sources:		
1. Other Revenue	$26	$7,237
2. Imputed Financing Sources	16,262	
Total	$16,288	$7,237

B. Other Information: The $16,262 represents the imputed financing for pensions and other retirements benefits. The Office of Personnel Management (OPM) is the administrative entity for pensions and other retirement benefits (ORB). OPM accounts for and reports the pension liability in the financial statements while the employer discloses the imputed financing. OPM actuaries provide the normal cost rates which are used to calculate the imputed financing.

Imputed Pension and Other Retirement Benefits (ORB) (in thousands):

CSRS/FERS Retirement	$11,442
Health	4,825
Life Insurance	15

Note 23. Program or Operating Expenses (in thousands): Not applicable.

Note 24. Cost of Goods Sold (in thousands):

A. Cost of Services Sold:	
1. Beginning Work-in-Process	$21,824
2. Plus: Operating Expenses	2,342,410
3. Minus: Ending Work-in-Process	34,739
4. Minus: Completed Work for Activity Retention	
Cost of Services Sold	$2,329,495

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B. Cost of Goods Sold from Inventory (using Latest Acquisition Cost):

1. Beginning Inventory - L.A.C.	$0
2. Less: Beginning Allowance for Unrealized Holding Gains (Losses)	
3. Plus: Purchases at Cost	
4. Plus: Customer Returns - Credit Given	
5. Plus: DLR Exchange Credits	
6. Less: Inventory Losses Realized	
7. Less: Ending Inventory - L.A.C.	
8. Plus: Ending Allowance for Unrealized Holding Gains (Losses)	
9. Less: Equity Transfers of Inventory to Others	
10. Plus: Equity Transfers of Inventory from Others	
11. Plus: Other	
a. Repair Cost Adjustment	
b. Beginning Allowance Adjustment from Prior Year	
12. Equals: Cost of Goods Sold from Inventory	$0

C. Cost of Goods Sold from Inventory (using Historical Cost):

1. Beginning Inventory	
a. Plus: Purchases at Cost	$0
b. Plus: Inventory Gains	
c. Minus: Inventory Losses	
2. Less: Ending Inventory	
Cost of Goods Sold	$0

D. Other Information: DFAS-CL: Line A 2 includes Intrafund Eliminations of ($196,335).

Note 25. Other Expenses (in thousands):

	1997	1996
A. Other Expenses:		
1. Pension, Health, and Life Insurance Benefits	$16,262	
2. Losses on disposition of assets	(2,393)	$4,286
Total	$13,869	$4,286

B. Other Information: This cost credit was based on the costing to FY 1997 of the remaining NBV of three Encore mid-tier platforms at Oklahoma City, Ogden and Columbus. The cost should have been charged to the prior period adjustment account so the cost was reversed. See Note 27.

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The $16,262 represents the imputed expense for pensions and other retirement benefits. The Office of Personnel Management (OPM) is the administrative entity for pensions and other retirement benefits (ORB). OPM accounts for and reports the pension liability in their financial statements while the employer discloses the imputed expenses. OPM actuaries provide the normal cost rates which are used to calculate the imputed expenses.

Imputed Pension and Other Retirement Benefits (ORB) (in thousands):

CSRS/FERS Retirement	$11,442
Health	4,825
Life Insurance	15

Note 26. Extraordinary Items (in thousands): Not applicable

Note 27. Prior Period Adjustments (in thousands):

A. Prior Period Adjustments:

1. Decrease due to fixed asset adjustments	($8,255)
2. Decrease of prior period obligations	(1,868)
3. Other prior year adjustments	(75)
Total	($10,198)

B. Other Information: The ($8,255) thousand adjustment reported above represents items inappropriately capitalized. The ($75) thousand adjustment shown above represents the net result of closing accounting activity on several legacy accounting systems (STANFINS, DBMS, STARS-FL, GAFS, SABRS, UDAPS-SP and legacy IFAS sites) and the "loss on disposal of equipment" discussed in Note 25. All accounting for the DMC business area is now on IFAS.

Footnote 28. Non-Operating Changes - (Transfers and Donations) (in thousands):

	1997	1996
A. Increases:		
1. Transfers-In:		
a. Transfers-Without Reimbursement-DWCF	$685	$135,692
b. Transfers-Without Reimbursement-Capital DWCF	(15,886)	
c.		
2. Unexpended Appropriations		
3. Donations Received		
4. Other Increases	2,816	
5. Total Increases	($12,385)	$135,692

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	1997	1996
B. Decreases:		
1. Transfers-Out:		
a. Transfers to Govt. Agency Without Reimbursement		$134,822
b. Transfers to All Others Without Reimbursement	$575	
c. Transfers to Others Without Reimbursement-DWCF		
d. Transfers to Others Without Reimbursement-Capital		
2. Donations		
3. Other Decreases	18,040	51,618
4. Total Decreases	$18,615	$186,440
C. Net Non-Operating Changes (Transfers):	($31,000)	($50,748)

D. Other Information: The ($15,886) credit above is under review by DFAS-Cleveland.

Note 29. Intrafund Eliminations (in thousands):

Schedule B: The DWCF-CISA sales component reports intrafund transactions (sales and services) within the overall DISA-DWCF (e.g., sales from CISA to DMCs).

The DWCF-DMC business area provides information services to the CISA via DITCO and other DMCs. These services include running applications on an IBM ES9221.

Selling Activity:

	Column A Accounts Receivable	Column B Revenue	Column C Unearned Revenue	Column D Collections
Supply Management	$0	$0	$0	$0
Distribution Depot				
Depot Maintenance				
Transportation Services				
Base Support				
Research and Development				
Information Services	2,437	29,242		29,242
Communication Services	14,296	167,093		164,290
Financial Services				
Commissary Operations				
Commissary Resale Stock				
Total	$16,733	$196,335	$0	$193,532

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Customer Activity:

	Column A Accounts Pay	Column B Expenses	Column C Advances	Column D Disbursements
Supply Management	$0	$0	$0	$0
Distribution Depot				
Depot Maintenance				
Transportation Services				
Base Support				
Research and Development				
Information Services	14,296	186,198		183,395
Communication Services	2,437	10,137		10,137
Financial Services				
Commissary Operations				
Commissary Resale Stock				
Total	$16,733	$196,335	$0	$193,532

Schedule C: DISA Consolidated Working Capital Fund Sales to DoD Entities

Selling Activity:

	Column A Accounts Receivable	Column B Revenue	Column C Unearned Revenue	Column D Collections
DISA Consolidated Working Capital Fund	$325,594	$2,087,881	$0	$2,051,867
Unearned Revenues				
Total	$325,594	$2,087,881	$0	$2,051,867

Customer Activity:

	Column A Accounts Payable	Column B Expenses	Column C Advances	Column D Disbursements
Department of the Army GF	$49,305	$327,126	$0	$303,134
Department of the Navy GF	34,741	236,247		227,637
Department of the Air Force GF	59,675	435,668		441,035
Army WCF	4,991	36,819		33,756
Air Force WCF	21,589	230,130		233,451
Defense WCFs	124,115	661,246		653,978
Navy WCFs	19,713	90,864		89,841
Other Defense Organizations	11,465	69,781		69,035
Total	$325,594	$2,087,881	$0	$2,051,867

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Schedule D: DISA Consolidated Working Capital Fund Sales to U.S. Government Entities

Selling Activity:

	Column A Accounts Receivable	Column B Revenue	Column C Unearned Revenue	Column D Collections
DISA Consolidated Working Capital Fund	$200,475	$359,558	$0	$368,965
Total	$200,475	$359,558	$0	$368,965

Customer Activity:

	Column A Accounts Payable	Column B Expenses	Column C Advances	Column D Disbursements
General Services Administration	$3,861	$1,001	$0	$919
State Department	11,745	8,620		4,744
Federal Aviation Agency	114,619	304,945		316,142
Department of Interior	876	1,631		2,113
Department of Treasury	4,607	862		2,312
NASA	462	615		259
U.S. Coast Guard	2,968	12,814		12,682
U.S. Department of Agriculture	2,541	1,062		47
Other U.S. Government Entities	58,626	27,788		29,689
Department of Transportation	170	220		58
Total	$200,475	$359,558	$0	$368,965

Note 30. Contingencies: See Note 17.

Note 31. Other Disclosures: At September 30, 1997 the cumulative differences between the Megacenter activities' and Treasury collections and disbursements were approximately $100 million and $500 million respectively, netting to an overall variance of $400 million. DFAS-Cleveland determined during the current fiscal year that approximately $300 million of cross-disbursements were not recorded at the activity level since fiscal year 1994. Liabilities related to these disbursements can not be identified at this time. Therefore, the status of obligations, expenses, and liabilities related to these disbursements is undetermined at this time. DFAS-Cleveland is in the process of working with Operation Location Pensacola, DISA and the other DFAS centers in resolving the cross-disbursement issue. This issue will be resolved in fiscal year 1998.

DEFENSE INFORMATION SYSTEMS AGENCY

DEFENSE-WIDE WORKING CAPITAL FUND

AUDIT OPINION

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

February 27, 1998

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

SUBJECT: Disclaimer of Opinion on the Defense Information Systems Agency Defense-Wide Working Capital Fund Financial Statements for FY 1997 (Project No. 8FH-2003)

The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibilities of management and auditors for the financial statements, internal controls, and compliance with laws and regulations. Fund managers are responsible for establishing and maintaining an internal control structure and for complying with laws and regulations applicable to the Defense Information Systems Agency Defense-Wide Working Capital Fund (the Fund). Our responsibility is to render an opinion on the financial statements based on our audit, and to determine whether internal controls are adequate and whether the Fund complied with applicable laws and regulations.

Before FY 1992, the DoD operated a significant number of commercial and industrial facilities under a revolving fund concept. In FY 1992, the revolving funds were consolidated to form the Defense Business Operations Fund (DBOF). The Inspector General, DoD, was responsible for auditing and rendering an opinion on the DBOF consolidated financial statements. In December 1996, the Under Secretary of Defense (Comptroller) restructured the DBOF into separate working capital funds. The Inspector General, DoD, is responsible for auditing and rendering an opinion on the financial statements, for FY 1997 and subsequent years, of the working capital fund reporting entities formerly reported under the DBOF.

Disclaimer of Opinion. We were unable to render an opinion on the Fund's Consolidated Financial Statements for FYs 1997 and 1996. Deficiencies in DoD accounting systems resulted in substantial undistributed collections and undistributed disbursements for the Defense Megacenters. The undistributed amounts were allocated to the Accounts Receivable balance (49 percent of total assets) and the Accounts Payable balance (85 percent of total liabilities). As a result, significant portions of the balances were unverifiable. In addition, we were unable to reconcile the beginning and ending consolidated balances for the Property, Plant, and Equipment account (26 percent of total assets). We requested that Defense Information Systems Agency personnel review the financial statement balances and explain changes. Personnel were unable to reconcile the changes shown on the financial statements with the beginning and ending balances. The Defense Information Systems Agency Financial Statements for 1996 were not reviewed.

Accounting Principles. The Fund's financial statements for FYs 1997 and 1996 were to be prepared in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16,

1996. These Bulletins incorporate the Statements of Federal Financial Accounting Concepts and Standards recommended by the Federal Accounting Standards Advisory Board, which are approved by the Secretary of the Treasury; the Director, OMB; and the Comptroller General of the United States. Footnote 1 of the Fund's financial statements discusses the significant accounting policies that the Defense Information Systems Agency followed in preparing the financial statements.

Internal Controls. We reviewed the internal control structure of the Fund and obtained an understanding of the internal control policies and procedures. In addition, we reviewed the implementation of the management control program by the Fund managers. We performed applicable tests of the internal control structure to determine whether the controls were effective and working as designed.

The internal control structure needs improvements in accounting for and managing resources, ensuring compliance with laws and regulations, and ensuring that the financial statements are free of material misstatements. For example, management needs to strengthen internal controls over the tracking of property, plant, and equipment. The Annual Statements of Assurance of the Defense Information Systems Agency did not identify any material weaknesses in accounting or financial reporting. However, the Annual Statements of Assurance of the Defense Finance and Accounting Service identified material weaknesses in undistributed and unmatched cross-disbursing and interfund transactions and in accounting and reporting for the Defense Working Capital Funds.

Compliance With Laws and Regulations. We assessed compliance with laws and regulations related to the financial statements. Management generally complied with the laws and regulations; however, improved compliance is needed for the $50 million in contingent liabilities for the Communications Information Services Activity and in accounting for the unbillable costs of services for the Defense Megacenters. Proposed adjustments in the areas mentioned would have a material impact on the financial statements. In addition, under the Federal Financial Management Improvement Act of 1996 and OMB Bulletin No. 93-06, Addendum 1, "Audit Requirements for Federal Financial Statements," January 16, 1998, our work disclosed that financial management systems did not comply with Federal financial management system requirements; applicable Federal accounting standards; and the U.S. Government Standard General Ledger at the transaction level.

David K. Steensma

David K. Steesma
Deputy Assistant Inspector General
for Auditing

Appendix D. Management and Legal Representation Letters

This appendix (a total of six pages) consists of the management and legal representation letters for the FY 1997 DISA Working Capital Fund Financial Statements.

DEFENSE INFORMATION SYSTEMS AGENCY
701 S. COURTHOUSE ROAD
ARLINGTON, VIRGINIA 22204-2199

IN REPLY REFER TO: Comptroller (DC)

27 February 1998

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Representation Letters for FY 1997 Defense Information Systems Agency Working Capital Fund Financial Statements

Reference: DODIG Memo, subject as above, 6 January 1998

1. In response to your memorandum, same subject, we are providing you with the requested representation letters and a synopsis of our responses to your audit questions. Our accounting processes are based on and conform to Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," 16 November 1993, and applicable portions of OMB Bulletin No. 97-01, same title, 16 October 1996. We confirm, to the best of our knowledge and belief, the following representations made to you during the audit.

a. We are responsible for the fair representation of the FY 1997 Defense Information Systems Agency Working Capital Fund Financial Statements in accordance with OMB Bulletin No. 94-01 and applicable portions of OMB Bulletin No. 97-01.

b. We have made available to you all financial records and related data.

c. We can provide reasonable assurance that the accounting and non-accounting systems used to produce the financial statements are reliable.

d. We have no plans or intentions, other than those previously disclosed to you, that may materially affect the carrying value or classification of assets and liabilities.

e. There have been no irregularities involving management of employees who have significant roles in the internal control structure.

f. No other employees have been involved in irregularities that could materially affect the financial statements.

g. We have received no communications from regulatory agencies or auditors concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

h. There are no indications of possible violations of laws or regulations to be disclosed in the financial statements or used as a basis for recording a loss contingency.

i. There are no other material liabilities, gain or loss contingencies that are required to be accrued or disclosed by Statement of Federal Financial Accounting Standard (SFFAS) No.5 "Accounting for Contingencies," December 1995.

j. There are no unasserted claims or assessments that our legal representatives have advised us must be disclosed in accordance with SFFAS No. 5.

k. There are no improperly recorded material transactions in the accounting records or financial statements.

l. The Department of Defense has satisfactory title to all assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged.

m. No events have occurred after the balance sheet date that would require adjustments to, or disclosure in, the financial statements.

n. We cannot attest to the accuracy of certain account balances (e.g, negative accounts payable and accounts receivable) provided by DFAS and used by us to prepare the financial statements.

o. All adjustments made to account balances by the responsible activity, the Defense Finance and Accounting Service, are fully documented and were made in accordance with applicable accounting standards.

2. If you have any questions regarding this memorandum, please contact Stewart Petchenick at (703) 607-6400.

EDWARD B. CODY
Acting Comptroller

DAVID J. KELLEY
Lieutenant General, USA
Director

DEFENSE INFORMATION SYSTEMS AGENCY
701 S. COURTHOUSE ROAD
ARLINGTON, VIRGINIA 22204-2199

IN REPLY REFER TO: Regulatory/General Counsel

27 February 1998

Mr. Jay Lane
Director, Finance and Accounting Directorate
Office of the Assistant Inspector General for Auditing
Department of Defense Information Systems Agency
400 Army Navy Drive
Room 944
Arlington, VA 22202-2884

Dear Mr. Lane:

In accordance with your instructions concerning the DODIG audit of FY1997 Defense Information Systems Agency Working Capital Fund financial statements (Project No. 8FH-2003), be advised that there are no material claims or assessments, pending, threatened or unasserted against the DISA Working Capital Fund, which, in my professional judgement and under the instructions, should be disclosed or considered for disclosure in DISA's financial statements.

If you have any questions regarding this information, please contact the undersigned at 703-607-6759.

CARL W. SMITH
General Counsel

Appendix E. Laws and Regulations Reviewed

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

Public Law 103-356, "Government Management Reform Act of 1994," October 13, 1994 (Federal Financial Management Act of 1994)

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 97-255, "Federal Managers Financial Integrity Act of 1982," September 8, 1982

OMB Bulletin No. 98-04, "Addendum to OMB Bulletin No. 93-06," January 16, 1998

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

OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993

OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993

Federal Accounting Standards Advisory Board Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995

DoD 7000.14-R, "DoD Financial Management Regulation," volume 6, "Reporting Policy and Procedures," January 1998

DoD 7000.14-R, "DoD Financial Management Regulation," volume 4, "Accounting Policy and Procedures," January 1995

DoD 7000.14-R, "DoD Financial Management Regulation," volume 11B, "Reimbursable Operations, Policy and procedures - Defense Business Operations Fund," December 1994

DoD 7000.14-R, "DoD Financial Management Regulation," volume 1, "General Financial Management Information, Systems, and Requirements," May 1993

DoD Directive 5010.38, "Management Control Program," August 26, 1996

DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996

Appendix F. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

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 Finance and Accounting Service
Director, Defense Information Systems Agency

Non-Defense Federal Organizations

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

Non-Defense Federal Organizations (cont'd)

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

Audit Team Members

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

F. Jay Lane
David F. Vincent
John A. Richards
Ronald L. Smith
Jermaine D. Lassiter
Frank C. Sonsini
Lusk Penn
Angela D. Clayton