INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND 
REGULATIONS FOR THE FY 1998 FINANCIAL STATEMENTS 
OF OTHER DEFENSE ORGANIZATIONS

Report No. 99-139

April 21, 1999

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Acronyms

CFO          Chief Financial Officers
DFAS        Defense Finance and Accounting Service
FFMIA      Federal Financial Management Improvement Act
FMFIA      Federal Managers' Financial Integrity Act
FMS          Financial Management Service
IG          Inspector General
OMB         Office of Management and Budget
TI          Treasury Index
SOP          Standard Operating Procedure
USD(C)     Under Secretary of Defense (Comptroller)
USGSL     U.S. Government Standard General Ledger
MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and
Regulations for the FY 1998 Financial Statements of Other Defense
Organizations (Report No. 99-139)

We are providing this report for review and comments. This audit was performed
in response to the Chief Financial Officers Act of 1990, as amended by the Federal
Financial Management Act of 1994. Findings A and B of this report address our
assessment of internal controls and compliance with laws and regulations.

DoD Directive 7650.3 requires that all recommendations be resolved promptly.
Because the Director, Defense Finance and Accounting Service, did not comment on the
draft report, we request that the Director provide comments on the final report by
May 21, 1999. If we receive comments to the draft report, we will regard them as
comments to the final report.

We appreciate the courtesies extended to the audit staff. Questions on the
audit should be directed to Mr. Charles J. Richardson at (703) 604-9582
(DSN 664-9582), email crichardson@dodig.osd.mil, or Mr. Marvin L. Peek at
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report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
For Auditing
Executive Summary

Introduction. We performed the audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires DoD and other Government agencies to prepare consolidated financial statements. The FY 1998 DoD Agency-wide financial statements include financial statements for a reporting entity entitled “Other Defense Organizations.” This entity represents a consolidation of financial information from various Defense organizations and funds, including the Military Departments, which use the Treasury Index 97 symbol, also referred to as Department 97. During FY 1998, the Defense organizations and funds included in the Other Defense Organizations entity received $54.1 billion in direct appropriations. The DoD entities included in Other Defense Organizations are listed in Appendix B

Objectives. The overall audit objective was to assess internal controls and compliance with laws and regulations used to compile the FY 1998 financial statements of Other Defense Organizations. Because the Defense Finance Accounting Service (DFAS) Indianapolis Center, Indianapolis, Indiana, did not provide financial statements to us in time for us to audit those statements, we focused on the internal controls over the process used to compile the “Report on Budget Execution for TI [Treasury Index] 97 Appropriations” (Report on Budget Execution). In a subsequent audit report, we plan to evaluate the procedures used to compile the FY 1998 financial statements for Other Defense Organizations.

Review of Internal Controls. The DFAS Indianapolis Center did not have effective internal controls in place to compile the FY 1998 financial statements for Other Defense Organizations in a reliable and timely manner (Finding A). Internal controls over the budget reporting process provided reasonable assurance that the DFAS Indianapolis Center accurately compiled amounts for budget authority and unobligated balances. However, the internal controls did not provide reasonable assurance that disbursements, collections, account payable, accounts receivable, and net obligations were accurately shown on the Report on Budget Execution. The DFAS Indianapolis Center made unsupported budgetary adjustments of $17.7 billion, an amount material to the FY 1998 DoD Agency-wide financial statements. The $17.7 billion included adjustments of $4.6 billion to collections, $1.5 billion to disbursements, $7.8 billion to accounts payable,
and $3.8 billion to accounts receivable. The effect of those adjustments on the Statement of Budgetary Resources and related financial statements will be identified in a subsequent report. The lack of transaction-driven general ledger accounting systems for Other Defense Organizations, the inability to implement prior IG, DoD, recommendations, and the lack of reconciliation procedures contributed to the ineffective internal controls (Finding B).

**Review of Compliance With Laws and Regulations.** We identified instances of noncompliance with laws and regulations related to the Chief Financial Officers Act, the Federal Financial Management Improvement Act, and the Federal Managers’ Financial Integrity Act. Our limited review of the compliance with laws and regulations did not disclose all instances of potential noncompliance with laws and regulations that may be considered material to the financial statements for the Other Defense Organizations reporting entity.

**Summary of Recommendations.** We recommend that the Director, DFAS Indianapolis Center, prepare a comprehensive action plan that documents and maps the processes and financial systems used to compile the financial statements for Other Defense Organizations, provides for continuous improvement through a dedicated organizational unit, and establishes measurable goals and milestones for compiling the financial statements.

We also recommend that the Director, DFAS Indianapolis Center, prepare an action plan to document the processes, procedures, and systems needed to reconcile disbursement and collection information with information on the status of budgetary resources; update standard operating procedures; develop and use a single, management-approved crosswalk to convert data from the SF 1176 format to the SF 133 format of the Report on Budget Execution; and ensure that personnel receive adequate training in preparing the Report on Budget Execution.

**Management Comments.** The Director, DFAS, did not comment on the draft report. Therefore, we request that the Director provide comments on the final report by May 21, 1999.
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Introduction

Background


Other Defense Organizations. Other Defense Organizations represent a consolidation of financial information from various Defense organizations and funds that use Treasury Index (TI) symbol (Department 97), including the Military Departments. During FY 1998, the Defense organizations and funds included in Other Defense Organizations received $54.1 billion in direct appropriations. Appendix B lists the organizations and funds included in Other Defense Organizations.

Accounting Functions and Responsibilities. The Defense Finance and Accounting Service (DFAS) was established in January 1991 to perform accounting functions for DoD. During FY 1998, DFAS accounting offices provided accounting support for Defense organizations that use Department 97 funds, except for:

- certain organizations supported by the Washington Headquarters Services Allotment Accounting System,
- the Tricare Support Office,
- organizations required to perform their own accounting because of security considerations, and
- a few other small organizations.

ensure the accuracy of the reports. Beginning in FY 1996, the DFAS Indianapolis Center, Indianapolis, Indiana, was responsible for preparing the financial statements for Department 97 funds.


Objectives

The overall audit objective was to assess internal controls and compliance with laws and regulations used to compile the FY 1998 financial statements of Other Defense Organizations. We also evaluated the DFAS Indianapolis Center internal controls and compliance with laws and regulations over the compilation and presentation of the "Report on Budget Execution for TI 97 Appropriations" (Report on Budget Execution) for Other Defense Organizations, which is the report used to compile the Statement of Budgetary Resources.

In a subsequent report, we will evaluate the procedures used to compile and make adjustments to the FY 1998 financial statements of Other Defense Organizations. Appendix A discusses the audit scope and methodology and lists prior audit coverage. Appendix B lists the DoD organizations and funds that compose the Other Defense Organizations. Appendix C lists the laws and regulations reviewed. Appendix D shows the report distribution.
Review of Internal Controls

Internal Control Responsibilities and Components

Internal Control Responsibilities. As the Chief Financial Officer, the Under Secretary of Defense (Comptroller) (USD[C]) oversees all financial management activities for DoD programs and operations, including the accounting functions of DFAS. Managers within Other Defense Organizations, supporting accounting offices, and the DFAS Indianapolis Center, Indianapolis, Indiana, are jointly responsible for establishing and maintaining effective internal controls. DoD Regulation 7000.14-R, volume 6A, “Reporting Policy and Procedures,” January 1998, states that DFAS shall establish internal controls to ensure that data provided by DoD Components are accurately and promptly recorded and processed in finance and accounting systems. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

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

- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation, 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 with any laws and regulations that OMB, DoD, or the IG, DoD, have identified as being significant and for which compliance can be objectively measured and evaluated.

Internal Control Components. DoD Directive 5010.38, “Management Control Program,” August 26, 1996, and DoD Instruction 5010.40, “Management Control Program Procedures,” August 28, 1996, implement section 3512, title 31, United States Code, which requires management to establish and maintain a comprehensive management control system, including internal controls, and to monitor and report on the system. Statement on Auditing Standards No 78, “Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No 55,” states that the internal control structure consists of five interrelated components:

- the control environment, which includes factors that set the tone of an organization, influencing the control consciousness of its employees,

- the risk assessment, which is an entity’s identification, analysis, and management of risks relevant to the preparation of financial statements following generally accepted accounting principles;
• control activities, which are the policies and procedures that help ensure that necessary actions are taken to address risks to achieving the entity’s objectives;

• information and communication, which includes the accounting system, consisting of the methods established to record, process, summarize, and report entity transactions and to maintain accountability of the related assets and liabilities; and

• monitoring, which assesses the quality of internal control performance over time.

Reportable Conditions

Definition. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization’s ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of internal controls does 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, or material to a performance measure or aggregation of related performance measures, and would not be detected in a timely manner by employees in the normal course of performing their functions.

Our consideration of internal controls would not necessarily disclose all reportable conditions, and would not necessarily disclose all reportable conditions that are material weaknesses.

Reportable Conditions. The DFAS Indianapolis Center was unable to prepare and provide financial statements to the IG, DoD, in time for the audit because it did not have sufficient procedures, systems, and controls in place. (See Finding A for details.) See Finding B for details on other significant deficiencies related to controls over the preparation of the Report on Budget Execution, which is used to support the Statement of Budgetary Resources.
Finding A. Controls Over Compilation of the Financial Statements for Other Defense Organizations

As described in previous audit reports, the DFAS Indianapolis Center has not yet developed an effective process for compiling accurate and reliable financial statements for Other Defense Organizations. The lack of an effective process, including adequate internal controls, for compiling the financial statements for Other Defense Organizations was evident in a November 23, 1998, Situation Report, which stated that the DFAS Indianapolis Center would be unable to produce timely financial statements for FY 1998. As of March 1, 1999, the DFAS Indianapolis Center had not prepared complete financial statements for Other Defense Organizations. The problems with financial statement preparation and reporting occurred because the DFAS Indianapolis Center:

- did not develop and implement a comprehensive compilation process that would accommodate the unique reporting structure of Other Defense Organizations, and
- did not provide adequate resources to implement a new compilation system.

As a result, the DFAS Indianapolis Center reported material amounts for Other Defense Organizations that were derived from improvised systems and manual processes. Some of these amounts, such as those reported for Fund Balance With Treasury ($31 billion) and Total Outlays ($56 billion) were material to the DoD Agency-wide financial statements for FY 1998. In addition, because of rigid time constraints, the financial information developed for the FY 1998 financial statements for Other Defense Organizations did not have the benefit of the normal internal review or our audit. Until the DFAS Indianapolis Center places a high priority on compiling the financial statements for Other Defense Organizations and implements effective financial processes and systems, account balances in the financial statements for Other Defense Organizations will remain unreliable and will affect the reliability of the DoD Agency-wide financial statements.

Problems Previously Reported

Prior IG, DoD, audit reports have stated that the process used by the DFAS Indianapolis Center to compile financial statements for the Other Defense Organizations was inadequate and did not produce accurate and reliable financial statements. Specifically, the DFAS Indianapolis Center did not:

- obtain explanations from submitting organizations for discrepancies between accounting records and summary information,
• thoroughly review financial information submitted by the supporting accounting offices for accuracy and completeness,
• adequately document year-end adjustments to provide audit trails,
• report the Fund Balance With Treasury based on general ledger accounting data, and
• prepare accurate and reliable financial statements in a timely manner.

Our most recent audit report on Other Defense Organizations\(^1\) showed that the same personnel at the DFAS Indianapolis Center who compile the Army General Fund financial statements also prepare the financial statements for Other Defense Organizations. Because the Army General Fund is larger and USD(C) requires an audit opinion on that fund, the financial statements for Other Defense Organizations appear to have a lower priority. However, account balances for Other Defense Organizations represent material amounts on the DoD Agency-Wide financial statements. For example, the Other Defense Organizations Fund Balance With Treasury of $31 billion and Total Outlays of $56 billion for FY 1998 represented 18 and 19 percent, respectively, of corresponding DoD amounts. Also, the Net Cost of Operations of $55 billion for Other Defense Organizations was 20 percent of the DoD Net Cost of Operations for FY 1998. Therefore, until the problems listed above are corrected, they will continue to materially affect the DoD Agency-wide financial statements.

**Attempts to Improve the Compilation Process**

The DFAS Indianapolis Center recognized that the compilation process used to prepare the financial statements for FYs 1996 and 1997 was flawed. However, the DFAS Indianapolis Center did not improve the compilation process for the FY 1998 statements.

**Comprehensive Compilation Process.** The compilation process for the FY 1998 financial statements was unsuccessful partially because the DFAS Indianapolis Center had not developed and implemented a comprehensive process that would accommodate the unique reporting structure for Other Defense Organizations. Historically, the DFAS Indianapolis Center has used similar procedures for compiling the Other Defense Organizations financial statements and the Army General Fund financial statements. However, Other Defense Organizations includes unique and distinct reporting entities that are not integrated into a single command structure like the Army. For example, financial data for Other Defense Organizations also come from systems used by the Air Force and Navy, which are significantly different from Army accounting and reporting systems. As a result, the accurate compilation of the Other Defense Organizations financial data requires increased attention by the DFAS Indianapolis Center for each reporting

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entity. The DFAS Indianapolis Center needs to establish a comprehensive plan of action for effectively compiling the financial information and preparing the financial statements for Other Defense Organizations.

Attempts to Implement a New Compilation System. The DFAS Indianapolis Center did not effectively implement a new automated compilation system, the Departmental Database-Direct Reporting system, which DFAS planned to use for the FY 1998 financial statement compilation process. Headquarters, DFAS, and the DFAS Indianapolis Center did not provide adequate resources to effectively implement the necessary system changes. During testing in September 1998, DFAS personnel determined that the new system was inadequate. However, the DFAS Indianapolis Center had not prepared a contingency plan in the event the new system failed. Also, because resources were concentrated on implementing the new system, DFAS did not update the automated system used in previous years.

In October 1998, the DFAS Indianapolis Center Systems Integration Directorate began preparing an alternate desktop application to compile financial statements. On November 23, 1998, the DFAS Indianapolis Center provided a Situation Report to the USD(C) and the Department of the Army, informing them that the financial statements would be delayed. The desktop application was used to prepare the Army General Fund and Army Working Capital Fund statements, but because of the complex reporting structure of the Other Defense Organizations, the DFAS Indianapolis Center could not use the desktop application to prepare complete financial statements for Other Defense Organizations. However, the DFAS Indianapolis Center CFO Team manually calculated financial data for Other Defense Organizations for inclusion in the DoD Agency-wide financial statements for FY 1998.

Conclusion

The problems identified in this report and prior reports will continue until DFAS provides sufficient resources and places increased management emphasis on preparing reliable and timely financial statements for Other Defense Organizations. Establishing a dedicated organizational unit responsible for compiling the financial statements for Other Defense organizations is essential if positive change is desired. Until the DFAS Indianapolis Center develops a comprehensive action plan for continuous improvement, to include measurable goals and milestones and documented testing, the financial statements for Other Defense Organizations will continue to be late and unreliable.
Recommendations

A. We recommend that the Director, Defense Finance and Accounting Service Indianapolis Center, prepare a comprehensive action plan for continuous improvement for the compilation of financial statements for Other Defense Organizations. Specifically, the action plan should:

1. Establish a dedicated organizational unit responsible for preparing the financial statements for Other Defense Organizations.

2. Develop, document, and map the processes and financial systems needed to compile the statements.

3. Test the processes and financial systems developed by compiling interim financial statements well before the end of FY 1999, and develop a viable contingency plan if the new systems cannot be activated.

4. Establish objective and measurable goals and milestones for providing financial statements in accordance with guidance issued by the Under Secretary of Defense (Comptroller).

5. Include short- and long-term goals for continuous improvement in the reliability of financial information.

Management Comments Required

DFAS did not comment on a draft of this report. We request that DFAS provide comments on the final report.
Finding B. Controls Over Compilation of the Report on Budget Execution

DFAS Indianapolis Center had effective controls and procedures to completely and correctly compile budget authority and unobligated balances for the "Report on Budget Execution for TI 97 Appropriations" (Report on Budget Execution), which is used to prepare the Statement of Budgetary Resources. However, controls and procedures did not provide reasonable assurance that disbursements, collections, accounts payable, accounts receivable, and net obligations were accurately compiled. In addition, the DFAS Indianapolis Center could not provide supporting documentation or audit trails for $17.7 billion in year-end adjustments to the FY 1998 Report on Budget Execution. Those adjustments included:

- adjustments of $4.6 billion to disbursements and $1.5 billion to collections that forced the Report on Budget Execution to match U.S. Treasury records, and

- adjustments of $7.8 billion to accounts payable and $3.8 billion to accounts receivable that resulted from the adjustments to disbursements and collections and appropriations canceled on September 30, 1998.

Controls were inadequate because the DFAS Indianapolis Center and the accounting offices supporting the Other Defense Organizations did not have integrated, transaction-driven general ledger accounting systems. In addition, controls continue to be ineffective because the DFAS Indianapolis Center did not implement recommendations in prior IG, DoD, reports. Those reports recommended that the DFAS Indianapolis Center reconcile the budgetary status data each month to expenditure data and U.S. Treasury data, and determine the causes of undistributed disbursements. Additionally, standard operating procedures were not current or adequate. As a result, the Report on Budget Execution could not be relied on to reflect material segments of the Statement of Budgetary Resources for Other Defense Organizations. The impact on the Statement of Budgetary Resources will be discussed in a subsequent report on the compilation of financial statements for Other Defense Organizations.

Budgetary Reporting Process

OMB Circular No. A-34, "Instructions on Budget Execution," November 7, 1997, requires Federal agencies to prepare SF 133, "Report(s) on Budget Execution," to provide current data on the status of each open U.S. Treasury account. The

2Our review of unobligated balances was limited to how the DFAS Indianapolis Center compiled the information received. We did not review the reliability of balances submitted to the DFAS Indianapolis Center.
Report on Budget Execution shows budgetary resources, the status of budgetary resources, and the relationship of obligations to outlays. The accounting offices that support Other Defense Organizations submit budgetary data to the DFAS Indianapolis Center, Defense Agency Team, which is responsible for budgetary reporting. The Defense Agency Team compiles the data, prepares monthly and year-end appropriation-level Reports on Budget Execution, and submits those reports to OMB, the USD(C), and Headquarters, DFAS. The reports are used to prepare the Statement of Budgetary Resources, one of the required financial statements.

Financial Systems

No single integrated system existed to support the budgetary reporting needed to prepare the Statement of Budgetary Resources, as required by OMB Circular No. A-127. This Circular requires each agency to establish and maintain a single, integrated financial management system that complies with accounting principles, internal control standards, and applicable OMB and U.S. Treasury requirements. Budgetary reporting for Other Defense Organizations relied on multiple systems that were not integrated. Funding was reported using the Program Budget Accounting System; the status of budgetary resources was reported using multiple accounting systems of the accounting offices that support the Other Defense Organizations; the Defense Agency Team at the DFAS Indianapolis Center used the TI 97 Application (database software) to compile the appropriation-level Report on Budget Execution; and the CFO Team at the DFAS Indianapolis Center used a separate desktop application to prepare the financial statements. Also, the system for reporting the status of budgetary resources to USD(C) and OMB was not integrated into the system for reporting expenditures to the U.S. Treasury.

Although DoD did not have a single, integrated system to support budgetary reporting, the DFAS Indianapolis Center had effective controls and procedures in place to provide reasonable assurance that budgetary authority and unobligated balances were accurately compiled for the Reports on Budget Execution. See Appendix A, Audit Process, for details of the internal control tests performed.

Adjustments to the Report on Budget Execution

The DFAS Indianapolis Center made unsupported adjustments to the Report on Budget Execution of $4.6 billion for disbursements, $1.5 billion for collections, $7.8 billion for accounts payable, and $3.8 billion for accounts receivable. The adjustments were made so that status reporting by accounting offices would

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3Status reporting is the combination of systems and processes used by accounting offices and consolidated at DFAS Centers for reporting the status of budgetary resources to the USD(C) and OMB.
match expenditure reporting by disbursing stations and the U.S. Treasury, and by subtracting accounts receivable from accounts payable for canceling appropriations.

Reconciliations to U.S. Treasury. The USD(C) agreed on a plan to report Fund Balance With Treasury in the financial statements based on the cash balances in the Fund Balance With Treasury general ledger accounts. DFAS agreed to identify and explain in footnotes the difference between amounts reported in the financial statements and amounts reported to the U.S. Treasury on Financial Management Service (FMS) Form 2108, "Year-End Closing Statement" (FMS 2108), which shows the status of budgetary appropriations and funds based on U.S. Treasury balances. Further, DFAS was to research and resolve any differences. However, the DFAS Indianapolis Center had not implemented the process.

The Defense Agency Team at the DFAS Indianapolis Center adjusted disbursements and collections on the Report on Budget Execution to match disbursements and collections reported by the U.S. Treasury on FMS Form 6653, "Undisbursed Appropriation Account Ledger" (FMS 6653). The Defense Agency Team used the adjusted Report on Budget Execution to prepare the FMS 2108 and forwarded the FMS 2108 to the CFO Team, which used the FMS 2108 to calculate Fund Balance With Treasury for the financial statements. As a result, the financial statements reflected balances based on U.S. Treasury records rather than the general ledger.

Previously Reported Problem. In FY 1997, the IG, DoD, reported that financial reports prepared by the DFAS Indianapolis Center did not contain reliable amounts for Fund Balance With Treasury because the DFAS Indianapolis Center did not adequately reconcile on a monthly basis the Department 97 expenditure data to the Department 97 budgetary data, and subsequently to the U.S. Treasury Government On-Line Accounting Link System data. The DFAS Indianapolis Center considered the differences between the data to be undistributed disbursements. To correct the control weakness, the IG, DoD, recommended that the Director, DFAS Indianapolis Center, reconcile current year expenditure data to the budget data and U.S. Treasury data and determine the causes of any undistributed disbursements. Although DFAS concurred, it had not implemented the recommendation. The recommendations in this report, if implemented, should help DFAS improve its systems to obtain the information needed to begin the recommended reconciliations and assist the supporting accounting offices with those reconciliations.

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4Expenditure reporting is the combination of systems and processes used by DoD disbursing stations and consolidated by DFAS Centers for reporting disbursements and collections to the U.S. Treasury.

5A November 30, 1998, memorandum from the USD(C) to DoD Components, "Department of Defense Implementation Strategy for Auditable Financial Statements," implemented various initiatives (including guidance on reporting Fund Balance With Treasury) to help DoD achieve an unqualified opinion on the DoD financial statements.

Adjustments to Match U.S. Treasury Records. Because the DFAS Indianapolis Center had not implemented the IG, DoD, recommendations, the DFAS Indianapolis Center continued to adjust budgetary status data to match U.S. Treasury records, and the control weakness continued to exist during FY 1998. Disbursements and collections reported to the USD(C) and OMB by accounting offices were not reconciled to those reported to the U.S. Treasury by disbursing stations. As a result, the DFAS Indianapolis Center Defense Agency Team adjusted disbursements by $4.6 billion and collections by $1.5 billion to make disbursements and collections on the Report on Budget Execution match disbursements and collections that DoD disbursing stations reported to the U.S. Treasury and the U.S. Treasury subsequently included on FMS 6653.

Inadequacies in Accounting Systems. The Defense Agency Team at the DFAS Indianapolis Center adjusted the Report on Budget Execution to force disbursements and collections reported by the accounting offices to match those reported by the disbursing stations. The disbursing stations disbursed and collected funds and sent the information to the U.S. Treasury, usually before those transactions were recorded in Other Defense Organizations accounting records. The DFAS Indianapolis Center considered the excess amounts of disbursements and collections reported to the U.S. Treasury from disbursing stations, in addition to what was reported by the accounting offices to USD(C) and OMB, to be the amounts not yet distributed and recorded in the general ledgers of the supporting accounting offices. Therefore, adjustments for the undistributed amounts were not supported by valid general ledger transactions at the supporting accounting offices.

Reconciling to the Appropriation Limit Level. Until an accounting system integrating both expenditure and status reporting is implemented, the DFAS Indianapolis Center should implement procedures to reconcile status data to expenditure data and identify differences at the appropriation limit level. Further identification of differences at the appropriation limit level would show to which Defense organization or fund the differences are attributable. The DFAS Indianapolis Center Treasury Support Teams receive transaction files from disbursing stations for all disbursements and collections charged to Department 97 appropriations; beginning in FY 1999, DFAS personnel created a balance by appropriation limit that is carried forward month to month. The balance, known as the Balance Forward, shows at the Defense organization level the disbursements, collections, and adjustments reported to the U.S. Treasury. A reconciliation between the Report on Budget Execution and the Balance Forward would show the differences between expenditure and status reporting, and would identify to which appropriation limit or which of the Other Defense Organizations

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7 Appropriation limits are the four-digit suffixes to the U.S. Treasury account number (basic symbol) that identify a subdivision of funds, restrict the amount or use of funds for a certain purpose, or identify sub-elements within the account for management purposes. For Other Defense Organizations, the appropriation limit shows the organization or fund for which the appropriation provides funding.

8 The Treasury Support Teams are the primary interface between the DFAS Indianapolis Center and U.S. Treasury and other DFAS Centers.
the differences are attributable. The Defense Agency Team should then use the reconciliation to support adjustments to the Report on Budget Execution and therefore improve the reliability of the Statement of Budgetary Resources.

Adjustments to Accounts Payable and Receivable. The Defense Agency Team made unsupported adjustments of $7.8 billion to accounts payable and $3.8 billion to accounts receivable, as shown on the Report on Budget Execution. Those adjustments resulted from adjustments made to disbursements and collections and from subtracting undistributed accounts receivable from undistributed accounts payable for canceling appropriations. As the team adjusted disbursements and collections to match the FMS 6653, they simultaneously adjusted accounts payable and accounts receivable, creating undistributed payables and receivables. Those adjustments were not supported by transactions in the general ledgers of the accounting offices supporting Other Defense Organizations, and therefore did not comply with Statement of Federal Financial Accounting Concepts No. 1, chapter 7, “How Accounting Supports Federal Financial Accounting,” which establishes the recording of transactions as the basis for financial reporting.

Key Accounting Requirement No.3, “Accounting for Receivables Including Advances,” requires transactions that affect accounts receivable to be recorded in a timely manner. The disbursing stations, DFAS Centers, and accounting offices supporting Other Defense Organizations did not have adequate internal controls to ensure that transactions affecting accounts receivable were recorded in the general ledgers of the supporting accounting offices in a timely manner. For example, the Department 97 Operation and Maintenance appropriation (Treasury symbol 97 3 0100), had undistributed balances of $424 million for accounts receivable and $184 million for undistributed accounts payable when the appropriation was canceled on September 30, 1998. To eliminate the undistributed balances, the Defense Agency Team subtracted the undistributed accounts receivable from the undistributed accounts payable, creating a negative $240 million undistributed accounts payable balance that was arbitrarily distributed to various Defense organizations. In a subsequent audit report on compilation, we will discuss the potential over- and understatements on the financial statements.

Standard Operating Procedures

Standard Operating Procedures (SOPs) for the Report on Budget Execution. The Defense Agency Team had 60 written SOPs that established procedures for preparing the Report on Budget Execution. Our review of those SOPs and the control procedures practiced by the Defense Agency Team identified inadequacies in the SOPs. The SOPs did not include standard time frames for retaining budgetary data submitted by the supporting accounting offices. As a

9DoD Regulation 7000.14-R, volume 1, shows 13 Key Accounting Requirements. Key Accounting Requirements are a composite of regulations issued by the General Accounting Office, OMB, the Department of the Treasury, and DoD. All DoD accounting systems must comply with Key Accounting Requirements.
result, budgetary data were retained from 3 months to several years. If supporting documentation is discarded before it can be reviewed, transactions cannot be audited. Also, the SOPs:

- were not updated to address the new budget execution format for the SF 133 required as of November 7, 1997;
- did not establish standard procedures for coordinating budgetary adjustments with accounting offices;
- did not require consistent documentation for adjustments to budgetary data; and
- lacked signatures to show that management had approved 26 of the 60 SOPs reviewed.

Effectiveness of SOPs. Although the SOPs required budgetary accountants to visually inspect the final version of the Report on Budget Execution for obvious errors, this control procedure did not function effectively. Our visual inspection showed that on the July 1998 Report on Budget Execution, the Defense Agency Team incorrectly classified as available $141.4 million of unobligated funds that had expired. We expanded our review and determined that expired funds were incorrectly reported during each of the first 11 months of FY 1998. We informed the Defense Agency Team of the error, which they corrected before preparing the year-end reports. The visual inspections by the Defense Agency Team could be improved by developing and requiring accountants to complete a standard checklist based on the SF 133 format for the Report on Budget Execution. The checklist should ensure that accountants review expired appropriations, balances brought forward, anticipated amounts, abnormal balances, and footnotes.

Standard Crosswalk. The control procedures used by the Defense Agency Team did not ensure that all of its budgetary accountants used the same crosswalk to transfer data from the previous SF 1176 format of the budgetary reports, used by some accounting offices, to the SF 133 format required by OMB. The accountants used at least three different crosswalks. Although our tests did not identify material errors related to the use of different crosswalks, the use of a single crosswalk that is dated and approved by the Defense Agency Team supervisor would be a sound practice.

Control Environment

Training. Of the 19 accountants and 1 supervisor on the Defense Agency Team, the supervisor was the only team member trained in the current format of the Report on Budget Execution. In the transition from the previous format to the new SF 133 format, lines have been deleted, added, and renamed. The control environment and the quality of control procedures, such as visual inspections, could be improved by ensuring that accountants preparing the reports are adequately trained in the definitions of each line and the general ledger accounts supporting each line on the SF 133.
Recommendations

B. We recommend that the Director, Defense Finance and Accounting Service Indianapolis Center:

1. Prepare an action plan documenting the processes and systems required to reconcile disbursement and collection information with information on the status of budgetary resources. The action plan should include specific procedures and timelines to:

   a. Reconcile the "Report on Budget Execution for TI 97 Appropriations" to the "Balance Forward" (disbursement and collection information received from disbursing stations and summarized by Other Defense Organizations or funds) so that undistributed disbursements and collections can be attributed to specific organizations and funds.

   b. Monitor undistributed disbursements and collections attributed to specific organizations and funds, and assist accounting offices in resolving undistributed disbursements and collections.

   c. Reduce undistributed disbursements and collections to amounts that will not materially affect the financial statements for Other Defense Organizations.

2. Update the Standard Operating Procedures used by the Defense Agency Team so that the procedures:

   a. Require that budgetary documents submitted by Other Defense Organizations be retained until completion of the annual internal control audit.

   b. Provide specific procedures for preparing the "Report on Budget Execution for TI 97 Appropriations" in the required SF 133 format.

   c. Establish standard procedures for coordinating and documenting budgetary adjustments with the accounting offices that support the Other Defense Organizations.

   d. Require management to review and approve Standard Operating Procedures.

   e. Develop a standard checklist for performing visual inspections of the final "Report on Budget Execution for TI 97 Appropriations."

3. Develop and use a single, management-approved crosswalk to convert data from the SF 1176 format to the SF 133 format of the "Report on Budget Execution for TI 97 Appropriations."

4. Ensure that the Defense Agency Team accountants who prepare the "Report on Budget Execution for TI 97 Appropriations" receive adequate training in the new format.
Management Comments Required

DFAS did not comment on a draft of this report. We request that DFAS provide comments on the final report.
Review of Compliance With Laws and Regulations

Reportable Noncompliance

Material instances of noncompliance are failures to follow requirements, laws, or regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant. We identified material instances of noncompliance related to the compilation of financial data for the Other Defense Organizations. Reportable noncompliance is summarized below. Recommendations concerning compliance with laws and regulations are in Findings A and B of this report.

Section 3512, title 31, United States Code, “Federal Financial Management Improvement Act of 1996” (FFMIA). Under the FFMIA, we are required to report whether the agency’s financial management systems substantially comply with Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger (USGSGL) at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin No. 98-08. Our test results disclosed instances in which the agency’s financial management systems did not substantially comply with the three requirements.

Federal Financial Management System Requirements. OMB Circular No. A-127, “Financial Management Systems,” July 23, 1993, requires financial management systems to provide complete, reliable, consistent, timely, and useful information. To achieve this goal, DoD and other Federal agencies must establish and maintain a single, integrated financial management system. In addition, the Joint Financial Management Improvement Program has published a series of “Federal Financial Management System Requirements” that establish standard requirements for Federal agencies’ integrated financial management systems. For FY 1998, the financial management systems that support Other Defense Organizations were deficient for the following reasons.

- The DFAS Indianapolis Center did not have a reliable financial system in place to prepare the FY 1998 financial statements of Other Defense Organizations in a timely manner. See Finding A.

- The financial systems used by the disbursing stations and the accounting offices supporting the Defense organizations did not interface effectively to record disbursements and collections in a timely manner at the accounting offices.

Federal Accounting Standards. Federal agencies reporting under the Government Management Reform Act of 1994 are to follow the Statements of Federal Financial Accounting Standards agreed to by the Director, OMB; the
Comptroller General of the United States; and the Secretary of the Treasury. Because the DFAS Indianapolis Center did not have a compilation system in place to prepare financial statements in time for the audit, we could not assess the degree to which the system and statements would be in compliance with Federal accounting standards.

**USGSGGL at the Transaction Level.** OMB requires Federal agencies to implement the USGSGGL in their financial systems at the transaction level. Federal agencies are permitted to supplement their application of the USGSGGL to meet agency-specific information requirements. However, agency standard general ledgers must maintain consistency with the USGSGGL. For FY 1998, DoD finance and accounting systems lacked a standard, transaction-driven general ledger using USGSGGL accounts. Further, because the financial systems used to report on budgetary resources were not integrated, the Report on Budget Execution included summary-level budgetary adjustments that were not supported by detailed transactions recorded in the general ledgers of the accounting offices supporting Other Defense Organizations. See Finding B.

Section 65, title 31, United States Code, “Federal Managers’ Financial Integrity Act of 1982” (FMFIA). The FMFIA requires that the head of each Executive agency evaluate its systems of internal accounting and administrative controls to determine whether such systems comply with the FMFIA and prepare an Annual Statement of Assurance for the President and the Congress, stating whether the agency is in compliance. In FY 1998, DoD and DFAS reported internal control weaknesses involving noncompliance with accounting principles, standards, and other requirements. The weaknesses directly related to the financial statements of Other Defense Organizations are discussed below.

**DoD FY 1998 Annual Statement of Assurance.** The DoD FY 1998 Annual Statement of Assurance reported two material weaknesses that directly affected the accuracy and reliability of the FY 1998 financial statements of Other Defense Organizations.

- **Financial Accounting Process and Systems.** DoD reported that its accounting systems were not always in compliance with generally accepted Government accounting standards or with internal control objectives. As a result, the quality of financial information was not always reliable, and financial management practices were sometimes inadequate. The new systems necessary to produce auditable financial statements are not expected to be in place for several years.

- **Financial Reporting of Real and Personal Property.** The FMFIA requires that property and other assets be safeguarded against waste, loss, misuse, or misappropriation. Recent audits have found unreliable financial balances of real and personal property. DoD reported that accounting systems for real and personal property were not in compliance with statutes and with guidance from the General Accounting Office, OMB, and DoD.

**DFAS FY 1998 Annual Statement of Assurance.** DFAS reported 47 uncorrected material weaknesses in its FY 1998 Annual Statement of Assurance. Of the 47 weaknesses, 11 directly affected the accounting data used
by the DFAS Indianapolis Center to prepare the FY 1998 financial statements of Other Defense Organizations and the FY 1998 DoD Agency-wide financial statements. These weaknesses, according to the DFAS FY 1998 Annual Statement of Assurance, were:

- untimely contract fund reconciliation process,
- reconciliation of suspense account balances,
- check issue reporting discrepancies,
- inadequate check issue reconciliation,
- interface between contract payment system and accounting systems,
- inadequate general ledger control and unreliable financial reporting,
- undistributed and unmatched cross-disbursing and interfund transactions,
- general ledger control and reconciliation,
- trial balance reporting for Defense organizations,
- problem disbursements, and
- property management within DFAS.


Management Actions. DoD management has realized that current accounting systems and controls were not designed to respond to new or changing functional requirements generated by operational needs or legislation. DoD and DFAS have begun numerous initiatives to correct systemic deficiencies in the accounting systems. Two of those initiatives are:

- **Biennial Plan.** DoD has acknowledged that its financial management systems have significant procedural and systemic deficiencies. In September 1998, DoD published the first DoD Biennial Financial Management Improvement Plan (the Biennial Plan), which identifies many impediments to achieving auditable financial statements, including financial management system deficiencies. The Biennial Plan is intended to be a strategic financial improvement plan that addresses financial management systems. The Biennial Plan does not identify specific remedial actions for financial management system deficiencies or include time frames for implementing such actions. The IG, DoD, issued a
separate report with recommendations to improve the Biennial Plan and make it a more comprehensive financial management system improvement document.

- **DFAS Systems Integration Directorate.** DoD has established the DFAS Systems Integration Directorate to consolidate and modernize all DoD accounting systems. The goals of the Directorate are to comply with applicable laws and regulations and improve DoD financial reporting. This centralized approach should improve accountability and financial reporting.
Appendix A. Audit Process

Scope

Reports Reviewed. We are not expressing any opinion on the FY 1998 Financial Statements of Other Defense Organizations. Our audit was designed to support the FY 1998 DoD Agency-wide financial statements. We were not able to review the FY 1998 Financial Statements of Other Defense Organizations because the DFAS Indianapolis Center did not provide the statements to us in a timely manner. However, we reviewed the Report on Budget Execution, which is the primary source of data for preparing the Statement of Budgetary Resources. We reviewed the procedures and controls used to accumulate the budgetary financial data; to make adjustments to the reports; to produce the appropriation-level reports submitted to OMB, USD(C), and DFAS; and to prepare the Statement of Budgetary Resources. We also reviewed the DoD and DFAS FY 1998 Annual Statements of Assurance and prior audit reports.

Amounts Reviewed to Obtain Reasonable Assurance. We performed internal control tests to obtain reasonable assurance that amounts reported on the September 30, 1998, Report on Budget Execution were accurately compiled. We did not test the reliability of the amounts submitted by the supporting accounting offices.

- **Budget Authority.** Excluding receipt accounts, we reviewed 100 percent, or $58.3 billion (absolute value) of FY 1998 Department 97 funding actions from October 1, 1997, through July 31, 1998. We reviewed 80 percent, or $4.3 billion of $5.3 billion, of FY 1998 transfers and reappropriations for Department 97.

- **Unobligated Balance Brought Forward October 1.** We determined that the $146.1 billion (absolute value) of unobligated balances reported on the FY 1997 Report on Budget Execution were completely brought forward to the FY 1998 Report on Budget Execution.

- **Unobligated Balances Currently Available.** Our review of 83.4 percent of the $5.1 billion (absolute value) of unobligated balances currently available showed that the balances were correctly compiled. Also, our review of 98.6 percent of the $725 million in adjustments included in those balances disclosed no material compilation errors.

- **Unobligated Balances Not Available.** We reviewed the compilation of 85.6 percent of the $3.9 billion (absolute value) of unobligated balances not available and 96.9 percent of $1.3 billion of adjustments included in those balances and found no material errors.
Scope Limitation. Our audit concentrated on the procedures and controls used to compile and report financial information for Other Defense Organizations. We did not review the validity of amounts in individual Reports on Budget Execution submitted by the Other Defense Organizations or the internal controls used to account for and report the FY 1998 account balances.

Accounting Principles. Accounting principles and standards for the Federal Government have been issued and are undergoing further development and refinement. 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. The Director, OMB, and the Comptroller General issue standards agreed on by the three officials.

Agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, October 16, 1996, as amended on November 20, 1998. The hierarchy includes: standards agreed to and published by the Director, OMB, the Secretary of the Treasury, and the Comptroller General of the United States; interpretations of the Statements of Federal Financial Accounting Standards issued by OMB; requirements for the form and content of financial statements outlined in OMB Bulletin No. 97-01; and accounting principles published by other authoritative sources.

DoD-wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to the following objective and goal:

**Objective:** Fundamentally reengineer the Department and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. (DoD-6)

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal:

**Financial Management Objective:** Strengthen internal controls. **Goal:** Improve compliance with the Federal Managers' Financial Integrity Act. (FM-5.3)

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the Department of Defense. This report provides coverage of the Defense Financial Management high-risk area.
Methodology

Auditing Standards. This audit was performed in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD, based on the objectives of the audit and the limitations to the scope described in the report. Accordingly, we included such tests of internal controls as were considered necessary.

Computer-Processed Data. We used computer-processed data in this audit; however, we did not confirm the reliability of the data because the accounting systems used to prepare the financial statements for Other Defense Organizations had serious limitations. The lack of reliable financial information was described as a material management control deficiency in the DoD Annual Statements of Assurance for FYs 1997 and 1998. The lack of reliable information did not adversely affect our analysis.

Audit Period and Locations. We performed this financial-related audit from October 1998 through January 1999 at the DFAS Indianapolis Center.

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

Summary of Prior Coverage


Appendix B. Other Defense Organizations

American Forces Information Service
Ballistic Missile Defense Organization
Defense Acquisition University
Defense Advanced Research Projects Agency
Defense Building Maintenance Fund
Defense Commissary Agency
Defense Contract Audit Agency
Defense Emergency Response Fund
Defense Finance and Accounting Service
Defense Health Program
Defense Homeowners Assistance Fund
Defense Information Systems Agency
Defense Intelligence Agency
Defense Legal Services Agency
Defense Logistics Agency
Defense Manpower Data Center Facility
Defense Medical Program Activity
Defense Prisoner of War/Missing Persons Office
Defense Reserve Mobilization Income Insurance Fund
Defense Security Assistance Agency
Defense Security Service
Defense Special Weapons Agency
Defense Support Projects Office
Defense Technology Security Administration
DoD Education Activity
DoD Education Benefits Fund
Federal Energy Management Program
Joint Chiefs of Staff
National Defense Stockpile Transaction Fund
National Imagery and Mapping Agency
National Security Agency
National Security Education Trust Fund
Office of Economic Adjustment
Office of the Inspector General
Office of the Secretary of Defense 10
On-Site Inspection Agency
Pentagon Reservation Maintenance Revolving Fund
Tricare Support Office
U.S. Court of Appeals for the Armed Forces
U.S. Special Operations Command
Voluntary Separation Incentive Trust Fund
Washington Headquarters Services
William Langer Jewel Bearing Plant Revolving Fund

10 Includes other Department 97 funds provided to Military Departments and Defense agencies.
Appendix C. Laws and Regulations Reviewed


Appendix D. 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)

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 Contract Audit Agency
Director, Defense Finance and Accounting Service
  Director, Defense Finance and Accounting Service Indianapolis Center
Director, Defense Logistics Agency
Inspector General, Defense Intelligence Agency
Inspector General, National Security Agency

Non-Defense Federal Organizations

Office of Management and Budget
General Accounting Office
  National Security and International Affairs Division
  Technical Information Center
Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

- Senate Committee on Appropriations
- Senate Subcommittee on Defense, Committee on Appropriations
- Senate Committee on Armed Services
- Senate Committee on Governmental Affairs
- House Committee on Appropriations
- House Subcommittee on Defense, Committee on Appropriations
- House Committee on Armed Services
- House Committee on Government Reform
- House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform
- House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
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This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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