Audit Report

INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR THE FY 1997 FINANCIAL STATEMENTS OF OTHER DEFENSE ORGANIZATIONS

Report No. 98-178 July 13, 1998

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Acronyms

DFAS	Defense Finance and Accounting Service
CFO	Chief Financial Officers
FFMIA	Federal Financial Management Improvement Act
FMR	DoD 7000.14-R, Financial Management Regulation
FMFIA	Federal Managers' Financial Integrity Act
IG	Inspector General
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
USGSGL	U.S. Government Standard General Ledger

INSPECTOR GENERAL
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July 13, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and Regulations for the FY 1997 Financial Statements of Other Defense Organizations (Report No. 98-178)

We are providing this audit report for information and use. This audit was performed in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994.

Part I of this report includes separate sections on internal controls and compliance with laws and regulations. Part II provides relevant appendixes for management's use. Because this report contains no recommendations, no written comments were required, and none were received.

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), e-mail crichardson@dodig.osd.mil, or Mr. Marvin L. Peek, at (703) 604-9587 (DSN 664-9587), e-mail mpeek@dodig.osd.mil. See Appendix E for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
For Auditing

Office of the Inspector General, DoD

Report No. 98-178 **July 13, 1998**
(Project No. 8FA-2010.00)

Internal Controls and Compliance With Laws and Regulations for the FY 1997 Financial Statements of Other Defense Organizations

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 for FY 1996 and each succeeding year. The DoD Consolidated Financial Statements for FY 1997 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 that use the Treasury Index 97 (Department 97) symbol, including the Military Departments. During FY 1997, the 44 Defense organizations and funds included in Other Defense Organizations received $39.1 billion in direct appropriations, and their financial statements showed total assets of $46.5 billion and liabilities of $222.2 billion. The list of the 44 Defense organizations and funds is shown in Appendix B.

Audit Objectives. The overall audit objective was to assess internal controls and compliance with laws and regulations used to compile the FY 1997 Financial Statements of Other Defense Organizations. In a subsequent audit report, we will evaluate the process used to compile, adjustment, and prepare footnotes to the financial statements.

Internal Controls. Internal controls did not ensure effective accounting, compilation, and presentation of the financial statements of Other Defense Organizations. The lack of transaction-driven general ledger accounting systems for Other Defense Organizations, and the lack of audit trails and reconciliation procedures contributed to the ineffective internal controls. As a result, the financial statements for Other Defense Organizations were not auditable or reliable. Part I.A. is our report on internal controls.

Compliance with Laws and Regulations. The Defense Finance and Accounting Service Indianapolis Center and the accounting offices that support Other Defense Organizations did not fully comply with the Chief Financial Officers Act, the Federal Managers' Financial Integrity Act, and the DoD Financial Management Regulation. Until significant improvements in the accounting systems and internal controls are made, financial statements for Other Defense Organizations will not be reliable and will not be in compliance with the applicable laws and regulations. Part I.B. is our report on compliance with laws and regulations. Appendix D lists the laws and regulations we reviewed.

Summary of Recommendations. We are not making recommendations in this report because the needed recommendations were made in prior audit reports or will be made in the future audit reports for IG, DoD, Project No. 7RF-2028, "Audit of the Consolidation Process for FY 1997 Financial Statements for Other Defense Organizations," and IG,

DoD, Project No. 8RF-2010.01, "Audit of the Compilation of FY 1997 Financial Statements for Other Defense Organizations." DoD has acknowledged the long-standing problems with noncompliant accounting systems and inadequate audit trails, and has taken actions to improve its financial management. The development of compliant accounting systems is years in the future. In the interim, DoD and DFAS managers must use alternatives to prepare reliable and auditable financial statements.

Management Comments. We provided a draft of this report to management on May 14, 1998. Because this report contains no recommendations, written comments were not required, and none were received. Therefore, we are publishing this report in final form.

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Part I - Audit Results

Audit Background

Introduction. Public Law 101-576, the "Chief Financial Officers [CFO] Act of 1990," November 15, 1990, requires Federal organizations to submit audited financial statements to the Director, Office of Management and Budget. Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires DoD and other Government agencies to prepare consolidated financial statements for FY 1996 and each succeeding year. The DoD Consolidated Financial Statements for FY 1997 include financial statements for a reporting entity entitled "Other Defense Organizations." The Inspector General (IG), DoD, is not required to render a separate opinion on the financial statements for Other Defense Organizations and funds. However, information from audits of the financial statements of Other Defense Organizations and funds contributed to the disclaimer of an audit opinion on the DoD Consolidated Financial Statements for FY 1997. The financial statements for Other Defense Organizations and funds are not included in this report but a copy can be provided upon request.

Other Defense Organizations. Other Defense Organizations represents a consolidation of financial information from various Defense agencies, organizations, and funds that use the Treasury Index 97 (Department 97) symbol, including the Military Departments. During FY 1997, the 44 Defense organizations and funds included in Other Defense Organizations received $39.1 billion in direct appropriations, and their financial statements showed total assets of $46.5 billion and liabilities of $222.2 billion. See Appendix B for a listing of the 44 Defense organizations and funds.

Accounting Functions and Responsibilities. The Defense Finance and Accounting Service (DFAS) was established in January 1991 to perform accounting functions for DoD. During FY 1997, 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.

DoD 7000.14-R, the "DoD Financial Management Regulation" (FMR), volume 6, chapter 6, "Form and Content of Audited Financial Statements," January 1998 (DoD Form and Content Guidance), requires DFAS to ensure that the process of preparing financial reports is consistent, timely, and auditable, and that controls are in place to ensure the accuracy of the reports. Beginning in FY 1996, the DFAS Indianapolis Center was responsible for preparing the financial statements for Department 97 funds.

Reporting Policy. Other Defense Organizations use the same DoD Form and Content Guidance as other DoD Components. That guidance implements Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. Note 1 of the Other Defense Organizations financial statements discusses the significant accounting policies followed in preparing the financial statements.

Audit Objective

The overall audit objective was to assess internal controls and compliance with laws and regulations used to compile the FY 1997 Financial Statements of Other Defense Organizations. Part I.A. is our report on internal controls. Part I.B. is our report on compliance with laws and regulations. In a subsequent report, we will evaluate the procedures used to compile and make adjustments to the FY 1997 Financial Statements of Other Defense Organizations. Appendix A discusses the audit scope and methodology. Appendix B provides a list of the 44 Defense organizations and funds. Appendix C gives details of prior audits.

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Part I. A. - Review of Internal Controls

Introduction

Audit Responsibilities. Our audit objective was to assess the adequacy of internal controls over the preparation of the financial statements for Other Defense Organizations. In planning and performing our audit of the financial statements for FY 1997, we evaluated the DFAS Indianapolis Center's internal controls over the compilation and presentation of financial statements for Other Defense Organizations. DoD has acknowledged and reported the use of noncompliant accounting systems, and prior audits have confirmed the conclusions reached by DoD. Therefore, we did not review accounting transactions performed for Other Defense Organizations.

Management Responsibilities. Managers within Other Defense Organizations, supporting accounting offices, and the DFAS Indianapolis Center are jointly responsible for establishing and maintaining effective internal controls. The FMR, volume 6, "Reporting Policy and Procedures," February 1996, 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 Elements. DoD Directive 5010.38, "Management Control Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996, implement title 31, United States Code, section 3512 (31 U.S.C. 3512), which requires management to establish and maintain a comprehensive management control system, including internal controls, and to monitor and report on the system. The internal control structure consists of three elements.

- Control environment is the collective effect 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 assurance that specific objectives will be achieved.

Reportable Conditions

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 of Other Defense Organizations. Deficiencies identified in previous audits continued to exist, including:

- the lack of complete, transaction-driven general ledger accounting control systems to accumulate financial information,

- the lack of sufficient audit trails for year-end adjustments totaling $97.4 billion, and

- the inability to perform tasks that are needed for sound internal controls, such as reconciling account balances.

See Finding A for details of the deficiencies.

Finding A. Internal Controls

Controls used to accumulate and report financial information for Other Defense Organizations did not provide reasonable assurance that the financial statements were accurate and reliable. Controls were not adequate because the DFAS Indianapolis Center and the supporting accounting offices did not have complete, transaction-driven general ledger accounting systems. In addition, the financial statements could not be relied on because the DFAS Indianapolis Center:

- could not provide supporting documentation for adjustments of $97.4 billion that were performed to make the general ledger accounts agree with the "Report(s) on Budget Execution,"

- did not obtain complete and timely general ledger trial balances from accounting offices that support Other Defense Organizations, and

- did not reconcile differences between the balances of Fund Balance With Treasury accounts for Other Defense Organizations with the balances reported by the Department of the Treasury. The differences amounted to $5.3 billion.

DoD and DFAS have taken numerous actions to correct the reported problems. However, the deficiencies that caused the Other Defense Organizations financial statements to be unreliable, such as inadequate accounting systems and insufficient audit trails, may not be fully corrected in time for the FYs 1998 and 1999 financial statements. Until improvements in the accounting systems and internal controls are made, financial statements for Other Defense Organizations may not be auditable or reliable.

Standard General Ledger Accounting Systems

The FMR, volume 1, "General Financial Management Information, Systems, and Requirements," May 1993, states that DFAS shall maintain and operate a central double-entry general ledger. The central general ledger and its subsidiary ledgers and reports should be the source of data for financial statements of the Military Departments and Defense agencies. The FMR, volume 1, also states that accounting systems and subsystems shall be fully integrated with the central general ledger.

Inadequate Accounting Systems. IG, DoD, Report No. 97-225, "Major Deficiencies Preventing Favorable Audit Opinions on the FY 1996 DoD General Fund Financial Statements," September 30, 1997, states that accounting systems supporting DoD General Funds did not have integrated, double-entry, transaction-driven general ledgers to compile and report reliable and auditable information. The information was not auditable because the accounting systems did not produce an audit trail of information from the occurrence of a transaction through its recognition in accounting records and ultimately to the General Fund financial

systems. The report also stated that noncompliant accounting systems were a long-standing scope limitation that would likely continue to cause auditors to disclaim opinions on the DoD financial statements.

Corrective Actions by DoD. DoD has acknowledged the long-standing problems with noncompliant accounting systems and inadequate audit trails, and has taken actions to improve its financial management. However, deficiencies in accounting systems, which were the major reason that auditors could not render opinions on the DoD financial statements, may not be fully corrected for years. While awaiting compliant accounting systems, DoD and DFAS managers must use other alternatives to prepare reliable and auditable financial statements for Other Defense Organizations and the Military Departments.

Supporting Documentation for Year-end Adjustments

Previously Reported Problems. IG, DoD, Report No. 97-155, "Internal Controls and Compliance With Laws and Regulations for the FY 1996 Financial Statements of the Other Defense Organizations Receiving Department 97 Appropriations," June 11, 1997, states that because of the lack of reliable accounting and financial information, the DFAS Indianapolis Center could not use the data in the Defense organizations' general ledger submissions to prepare the financial statements for Other Defense Organizations. Therefore, the DFAS Indianapolis Center had to adjust the Defense organizations' general ledger balances to match the account balances in the "Report(s) on Budget Execution" before preparing the financial statements. Because DFAS could not determine the specific reasons for the differences between the "Report(s) on Budget Execution" and the general ledger submissions, the adjustments could not be supported. For example, the DFAS Indianapolis Center was unable to support $88.3 billion in year-end adjustments for FY 1996. As a result, the DFAS Indianapolis Center could not comply with Key Accounting Requirement[1] No. 8, "Audit Trails," which states that financial transactions in an accounting system must be adequately supported with pertinent documents and source records.

Adjustment to Trial Balances. The internal control weakness related to Key Accounting Requirement No. 8 still exists. The DFAS Indianapolis Center made three sets of adjustments totaling $97.4 billion to the FY 1997 trial balances for Other Defense Organizations to make the general ledger accounts agree with the "Report(s) on Budget Execution." However, the DFAS Indianapolis Center did not have documentation to support any of the adjustments. Accounting personnel at the DFAS Indianapolis Center stated that many of the year-end adjustments could have been eliminated or documented in detail if the supporting accounting offices had submitted monthly trial balances. We will make recommendations to correct problems related to interim processing of trial balances in a forthcoming

[1]The FMR, 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 the Key Accounting Requirements.

report on our "Audit of the Consolidation Process for FY 1997 Financial Statements for Other Defense Organizations." Project No. 7RF-2028.

Year-end Trial Balance Submissions

Because of the lack of transaction-driven standard general ledger accounting systems, the DFAS Indianapolis Center did not use general ledger source data from the accounting systems to produce the financial statements for Other Defense Organizations. Instead, the DFAS Indianapolis Center used a combination of the Defense organizations' year-end trial balances and the "Report(s) on Budget Execution" to produce the statements. To complete the financial statements and present them to OMB by the March 1, 1998, deadline, the DFAS Indianapolis Center needed to receive all year-end adjusted trial balances by October 1997.

As of November 1, 1997, 11 of the 14 accounting offices supporting the 44 Defense organizations and funds had not submitted their year-end trial balances to the DFAS Indianapolis Center. Of the 11 organizations, 8 were unable to produce trial balances from general ledgers; therefore, the DFAS Indianapolis Center had to prepare incomplete trial balances using the information from the "Report(s) on Budget Execution." "Report(s) on Budget Execution" cannot substitute for the entire trial balance because information such as equipment and operating expenses can only be found in trial balances produced by general ledger accounting systems. Therefore, the balances reported on the Other Defense Organizations financial statements were unreliable for some line items.

Reconciliation of Fund Balance With Treasury Account

IG, DoD, Report No. 97-155 states that the DFAS Indianapolis Center had not developed an adequate process for reconciling the differences for the Department 97 expenditure data and information in the Department of the Treasury's Government On-Line Accounting Link System. As a result, the amount reported as Fund Balance With Treasury in the financial statements was not reliable.

Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," March 30, 1993, requires Federal entities to reconcile and explain any discrepancies between the Fund Balance With Treasury amount in their general ledger accounts and the Department of the Treasury's accounts, and to explain the causes of the discrepancies in the footnotes to the financial statements. Also, discrepancies due to time lags should be reconciled, and discrepancies due to errors should be corrected when the financial statements are prepared. At the end of FY 1997, the difference between the Department 97 accounting records and the Department of the Treasury records for the Fund Balance With Treasury accounts was $5.3 billion.

Personnel at the DFAS Indianapolis Center were working to increase access to detailed transactions from the supporting accounting offices that would allow the reconciliation of Department of the Treasury records. If a new automated system,

the Shared Data Warehouse, is completed during FY 1998, internal controls over the reconciliation process will be significantly improved.

Conclusion

We are not making recommendations because the needed recommendations were made in prior audit reports, or will be made in a future audit report under IG, DoD, Project No. 8FA-2010.00, "Audit of the Compilation of the FY 1997 Financial Statements for Other Defense Organizations."

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

Introduction

We evaluated the financial statements for Other Defense Organizations for material instances of noncompliance with laws and regulations for FY 1997 to obtain reasonable assurance that the financial statements were compiled and presented in accordance with applicable laws and regulations. As part of obtaining reasonable assurance on whether the financial statements were free of material misstatements, we tested compliance with the laws and regulations listed in Appendix D.

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.

Title 31, U.S.C. 3512, "Federal Financial Management Improvement Act of 1996." On September 9, 1997, OMB issued a memorandum, "Implementation Guidance for the Federal Financial Management Improvement Act (FFMIA) of 1996." The FFMIA requires Federal agencies to implement and maintain financial management systems that comply substantially with Federal 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 Federal requirements and accounting standards and the USGSGL. These requirements are well-established in the following Federal policy documents:

- 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 that financial management systems 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 using 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 that Executive Branch agencies and OMB are to follow in seeking and providing interpretations and other advice related to the standards.

- The Joint Financial Management Improvement Program (JFMIP) is a cooperative undertaking of the OMB, the Department of the Treasury, and the Office of Personnel Management, working 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 part of the JFMIP "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 measuring performance.

As part of our audit to obtain reasonable assurance about whether the FY 1997 Financial Statements of Other Defense Organizations were free of material misstatement, we performed tests of their compliance with certain provisions of laws and regulations when noncompliance could have a direct and material effect on the amounts in the financial statements. We also tested compliance with certain other laws and regulations specified in OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1998, as modified by OMB Bulletin No. 98-04, "Addendum to OMB Bulletin No. 93-06," January 16, 1998. In planning and performing our tests of compliance, we considered the implementation guidance issued by OMB on September 9, 1997, relating to the FFMIA.

For FY 1997, the financial management systems that support the Other Defense Organizations 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. As a result, the financial condition of DoD and its operating results for FY 1997 are not verifiable, and DoD has no assurance that it is properly managing its resources.

Compliance with Laws and Regulations by Other Defense Organizations. DoD and DFAS have recognized and reported that accounting systems used for Other Defense Organizations are not in full compliance with the CFO Act and are taking actions to correct those deficiencies. Also, in presenting the Other Defense Organizations Statement of Financial Position for FY 1997, the DFAS Indianapolis Center overstated liabilities by $483 million because the statements did not comply with DoD Form and Content Guidance. See Finding B for details of the deficiencies.

Finding B. Compliance With Laws and Regulations

The DFAS Indianapolis Center and the accounting offices that support Other Defense Organizations did not fully comply with the CFO Act, the Federal Managers' Financial Integrity Act, and the FMR. The lack of compliance with laws and regulations occurred because the accounting systems used to compile and report financial information did not have integrated, double-entry, transaction-driven general ledgers. Also, the DFAS Indianapolis Center did not follow DoD guidance when reporting accounts payable and receivable. As a result, the financial statements prepared for Other Defense Organizations were not reliable. Until the existing systems are replaced and adequate controls are in place, the DFAS Indianapolis Center and the accounting offices supporting the Defense organizations and funds included in Other Defense Organizations will not be able to fully comply with the applicable laws and regulations.

Chief Financial Officers Act

IG, DoD, Report No. 97-225 states that noncompliant accounting systems and the associated insufficient audit trails were the major reasons for disclaimers of opinion on the FY 1996 DoD General Fund financial statements. The accounting systems and associated audit trail deficiencies identified in IG, DoD, Report No. 97-225 were the principal accounting systems used to support the 44 Defense organizations and funds listed in Appendix B.

Deficiencies Acknowledged by DoD. DoD has acknowledged that its financial management systems have significant procedural and systemic deficiencies, and included a discussion of those deficiencies in its FY 1997 Annual Statement of Assurance. The procedural and systemic problems include:

- inaccurate or incomplete cost accounting information,
- improper or incomplete accrual accounting,
- inadequate accounting for Government-furnished property, and
- lack of integrated financial systems.

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 legislative action. DoD and DFAS have begun numerous initiatives to correct systemic deficiencies in the accounting systems. However, the noncompliant accounting systems and inadequate audit trails that prevent DoD from full compliance with the CFO Act may not be fully corrected for years. These problems will continue to exist until new accounting systems are fully operational.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires that the heads of each Executive agency evaluate their 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 1997, DoD and DFAS reported internal control weaknesses involving noncompliance with accounting principles, standards, and other requirements. The weaknesses most directly related to the financial statements of Other Defense Organizations are discussed below.

DoD FY 1997 Annual Statement of Assurance. The DoD FY 1997 Annual Statement of Assurance reported two material weaknesses that directly affected the accuracy and reliability of the FY 1997 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 management 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 a number of 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 are not in compliance with statutes and with guidance from the General Accounting Office, OMB, and DoD.

DFAS FY 1997 Annual Statement of Assurance. DFAS reported 46 uncorrected material weaknesses in its FY 1997 Annual Statement of Assurance. Of the 46 weaknesses, 11 had a direct effect on the accounting data used by the DFAS Indianapolis Center to prepare the Other Defense Organizations financial statements and the DoD consolidated financial statements. These weaknesses, according to the Annual Statement of Assurance, were:

- inadequate internal controls over the funds availability for DFAS financial systems,
- untimely contract fund reconciliation process,
- reconciliation of suspense account balances,
- check issue reporting discrepancies,
- 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 agencies,
- problem disbursements, and
- property management within DFAS.

Management Actions. DoD has established the Defense Accounting System Program Management Office to consolidate and modernize all DoD accounting systems. The goals of that office are to comply with applicable laws and regulations and improve DoD financial reporting. This centralized approach should improve accountability and financial reporting.

DFAS did not report in its FY 1997 Annual Statement of Assurance on the feeder systems owned by the Military Departments in FY 1997, and has notified OMB that the FY 1997 Annual Statement of Assurance did not include this information. DFAS is identifying systems and developing an inventory of Military Department-owned feeder systems and plans to report on these systems for FY 1998.

DoD Financial Management Regulation

The DFAS Indianapolis Center did not comply with DoD Form and Content Guidance in the FMR because the FY 1997 Financial Statements of Other Defense Organizations did not include accounts payable and receivable for canceled appropriations. As a result, the balance reported for liabilities was overstated by about $483 million.[2] and accounts receivable was understated by about $68 million.

The FMR requires accounts payable and receivable on the financial statements to include amounts established under accounts that are now canceled. DFAS included accounts payable and receivable from canceled appropriations that had been reopened. However, the DFAS Indianapolis Center did not report all liabilities and accounts receivable from canceled appropriations. We will make recommendations to correct this noncompliance in a forthcoming report on our "Audit of the Compilation of Financial Data for Other Defense Organizations Into the Consolidating DoD Financial Statements," Project No. 8RF-2010.01.

[2]The "Report(s) on Budget Execution," September 30, 1997, showed a negative $468 million as the balance for accounts payable for canceled appropriations that had not been reopened. A negative accounts payable indicates an amount receivable by an entity. Most negative accounts payable for canceled appropriations represented undistributed disbursements.

Conclusion

We are not making recommendations because the needed recommendations were made in prior audit reports, or will be made in a future audit report under IG, DoD, Project No. 8RF-2010.01, "Audit of the Compilation of Financial Data for Other Defense Organizations Into the Consolidating DoD Financial Statements."

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Part II - Additional Information

Appendix A. Audit Process

Scope

Statements Reviewed. In accordance with our agreement with the Under Secretary of Defense (Comptroller), we are not expressing any opinion on the Other Defense Organizations Financial Statements. Our audit is designed to support the overall opinion of the DoD Consolidating Financial Statements. We reviewed the FY 1997 Other Defense Organizations Statements of Financial Position and Statement of Operations and Changes in Net Position. These statements were provided to us on December 22, 1997, and January 29, 1998. We also reviewed the procedures and controls that the DFAS Indianapolis Center used to accumulate financial data, make adjustments to trial balances, and produce the financial statements for Other Defense Organizations. In addition, we reviewed the supporting documentation for the adjustments that the DFAS Indianapolis Center made to the financial statements. As of January 16, 1998, the DFAS Indianapolis Center had made 78 adjustments, valued at about $100.1 billion, to the FY 1997 Financial Statements of Other Defense Organizations. We also reviewed the DoD and DFAS FY 1997 Annual Statements of Assurance and prior audit reports.

Scope Limitations. 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 trial balances submitted for Other Defense Organizations, or the internal controls used to account for and report the FY 1997 account balances.

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. The Director, OMB, and the Comptroller General issue standards agreed on by the three officials.

To date, seven accounting standards and two accounting concepts have been published in final form. Another standard, 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. 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 modified 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 for the Federal Government, 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 Federal 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 modified 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 the form and content of financial statements outlined in OMB Bulletin No. 94-01, as modified 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.

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 achievement of the objective to fundamentally reengineer the Department and achieve a 21st century infrastructure. The goal is to 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 Financial Management functional area objective to strengthen internal controls. The goal is to 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 in 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 Other Defense Organizations' financial statements have serious limitations. The lack of reliable financial information is described as a material management control deficiency in the DoD Annual Statements of Assurance for FYs 1996 and 1997. The lack of reliable information did not adversely affect our analysis.

Audit Period and Locations. We performed this financial-related audit from December 1997 through March 1998 at the DFAS Indianapolis Center.

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

Appendix B. Defense Organizations and Funds Included In Other Defense Organizations

Defense Organization	FY 1997 Funding ($ in millions)
American Forces Information Service	$ 112.2
Ballistic Missile Defense Organization	4,094.1
Base Realignment and Closure	2,218.7
Building Maintenance Fund, Defense	0
Court of Military Appeals	6.6
Defense Commissary Agency Surcharge Account	0
Defense Acquisition University	94.7
Defense Advanced Research Projects Agency	2,066.5
Defense Contract Audit Agency	329.1
Defense Health Program	10,022.4
Defense Information Systems Agency	939.9
Defense Legal Services Agency	8.1
Defense Logistics Agency	1,630.4
Defense Medical Programs Agency	326.1
Defense Security Service	203.7
Defense Special Weapons Agency	669.3
Defense Technology Security Administration	11.1
Defense Finance and Accounting Service	103.8
DoD Education Activity	1,391.8
Education Benefits Fund	211.0
Emergency Response Fund, Defense	0
Federal Emergency Management Program	0
Foreign National Employees Separation Pay Account	17.0
Homeowners Assistance Fund	128.0
Joint Staff	638.6
National Security Education Trust Fund	4.5
Tricare Support Office	209.8
Office of Economic Adjustment	49.8
Office of the Inspector General	139.1
Office of the Secretary of Defense (OSD)	2,039.1
On-Site Inspection Agency	68.4
Other "97" Funds Provided to the Air Force by OSD	789.1
Other "97" Funds Provided to the Army by OSD	1,086.0
Other "97" Funds Provided to the Navy by OSD	404.0
Other "97" Funds Provided to WHS by OSD	646.1
Pentagon Reservation Building Maintenance Fund	0
Prisoner of War/Missing Persons Office	12.6
US Special Operations Command	1,788.3
Voluntary Separation Incentive Trust Fund	203.3
Washington Headquarters Services	989.9
William Langer Jewel Bearing Plant Revolving Fund	0
Other*	5,435.7
Total	**$39,088.8**

*Three Intelligence and Security Community Organizations.

Appendix C. Prior Audit Reports

The IG, DoD, has issued several audit reports related to the compilation of the financial statements for Other Defense Organizations. Reports that discuss the FY 1996 financial statements include the following.

Report No. 98-062, "Compilation of the FY 1996 Financial Statements for Other Defense Organizations," February 4, 1998. This report states that the compilation process used by DFAS Indianapolis Center needed improvements to ensure that the financial statements were complete, consistent, accurate, and fully supported. Specifically, the DFAS Indianapolis Center:

- made year-end adjustments, totaling $88.3 billion and not fully supported, to the FY 1996 trial balances submitted by the supporting accounting offices;

- understated the financial statements by $207 million in assets, $1.4 billion in liabilities, $308 in net position, and $2.2 billion in expenses by omitting information from certain appropriations; and

- prepared inaccurate and incomplete Notes to the financial statements, and did not prepare all the required Notes.

As a result, the FY 1996 Financial Statements of Other Defense Organizations were not reliable and did not accurate or completely present the financial condition and results of operations. The report recommended that DFAS include all required Notes to the financial statements, disclose deficiencies in accounting systems that could affect the reliability of balances, and fully explain summary adjustments made to trial balances submitted by supporting accounting offices. DFAS concurred with the recommendations and stated that corrective actions were completed.

Report No. 98-027, "Comprehensiveness of the FY 1996 Other Defense Organizations Financial Statements," November 28, 1997. This report states that the FY 1996 financial data, prepared by the DFAS Indianapolis Center for the Other Defense Organizations financial statements, were not comprehensive. The DFAS Indianapolis Center excluded from the FY 1996 financial statements:

- part or all of 11 appropriation accounts that were reopened by the Department of the Treasury;

- certain canceled and merged appropriation accounts that could not be closed because of negative balances; and

- portions of 14 open appropriation accounts.

As a result, the amounts shown for six lines in the Statement of Financial Position were inaccurate. The report recommended that the Director, DFAS Indianapolis Center:

- report the total operations of Other Defense Organizations as reflected in the fiscal year-end "Report(s) on Budget Execution," and make appropriate adjustments to the FY 1997 beginning balances;

- modify the automated systems to include the total operations of Other Defense Organizations, and adjust the beginning balance of accounts to be included in the FY 1997 Statement of Financial Position; and

- review the staffing requirements needed to successfully compile the financial statements for Other Defense Organizations.

DFAS stated that DoD policy prohibited making changes to prior-year balances on the financial statements. DFAS concurred with the remaining recommendations and stated that corrective actions were being taken.

Report No. 97-225, "Major Deficiencies Preventing Favorable Audit Opinions on the FY 1996 DoD General Fund Financial Statements," September 30, 1997. This report summarizes major deficiencies preventing favorable audit opinions on the FY 1996 DoD General Fund Financial Statements. Although progress has been made toward achieving compliant accounting systems, the overarching deficiency continues to be the lack of compliant accounting systems for compiling accurate and reliable financial data. Auditors recommended $202 billion in adjustments; however, they were unable to render favorable audit opinions on the FY 1996 General Fund Financial Statements prepared for the Army; the Navy; the Air Force; and the U.S. Army Corps of Engineers, Civil Works Program, because the existing accounting systems:

- did not contain audit trails;

- could not support several amounts for reported assets, liabilities, and expenses; and

- produced unreliable financial data.

Until integrated, double-entry, transaction-driven general ledger accounting systems are developed and implemented for DoD General Fund accounting, and adequate audit trails exist, neither management nor the auditors will be able to obtain sufficient evidence to satisfy themselves as to the fairness of the financial statements. This significant limitation on the audit scope is the primary factor preventing favorable audit opinions on the DoD General Fund financial statements.

DoD has taken numerous actions to achieve more effective financial controls and produce more reliable financial information. Future financial statements will also be improved by making adjustments recommended by the auditors to clarify the presentation of financial data. The summary report contains no recommendations because the needed recommendations were made in other audit reports.

Report No. 97-155, "Internal Controls and Compliance with Laws and Regulations for the FY 1996 Financial Statements of the 'Other Defense Organizations' Receiving Department 97 Appropriations," June 27, 1997. This report states that the financial statements for Other Defense Organizations were not accurate and reliable. Unless improvements in accounting systems and internal controls are made, the future financial statements for Other Defense Organizations will not be reliable. The DFAS Indianapolis Center and the accounting offices supporting Other Defense Organizations were unable to fully comply with applicable laws and regulations. As a result, the financial statements of Other Defense Organizations were not in full compliance with the CFO Act and the FMFIA. The report recommended that the Director, DFAS Indianapolis

Center, maintain records for audit trails of all adjustment transactions; reconcile the current-year Department 97 expenditure data for the Fund Balance With Treasury account to the Department of the Treasury data; and document the review process used and decisions made regarding the auditors' recommended adjustments to the Principal Statements, including the footnotes. The DFAS Indianapolis Center did not agree that the lack of detailed transactions associated with the summary journal vouchers constituted a lack of audit trails. However, the DFAS Indianapolis Center partially concurred with the recommendation to maintain audit trails, suggesting that it also be directed to the organizations included in Other Defense Organizations. The DFAS Indianapolis Center concurred with the recommendations to establish procedures for reviewing auditor-recommended adjustments with the auditors, and stated that DFAS will work closely in the future with the IG, DoD, to develop a mutually agreeable process to coordinate adjustments and footnote disclosures.

Report No. 97-110, "Material Accounting and Management Control Weaknesses in the Defense Agencies' FYs 1995 and 1996 Financial Information," March 17, 1997. The report states that weaknesses in the Defense agencies' FYs 1995 and 1996 accounting systems were primarily related to four Key Accounting Requirements:

- General Ledger Control and Financial Reporting,
- Property and Inventory Accounting,
- System Controls (Fund and Internal), and
- Accrual Accounting.

The report also identified weaknesses in Defense agency accounting systems related to six additional Key Accounting Requirements: Accounting for Receivables Including Advances; Audit Trails; Cash Procedures and Accounts Payable; System Documentation; System Operations; and User Information Needs. The Defense agencies took aggressive actions to correct certain material weaknesses in accounting systems and management controls identified in FY 1994. However, actions to correct other weaknesses were in process, had not been started, or may not be completed until FY 1998 at the earliest. DoD initiatives will significantly improve the accuracy and integrity of financial information. However, several initiatives need to be tested and implemented to fully measure their success. The report made no recommendations.

Report No. 97-079, "Documentation of the Federal Financial System Process at the Defense Finance and Accounting Service Indianapolis Center," January 24, 1997. This report states that the DFAS Indianapolis Center's process for receiving, adjusting, and consolidating the general ledger trial balances from supporting accounting offices was not documented as required by the FMR. As a result, general ledger account balances could not be effectively tested to ensure the reliability of the trial balances reported for Department 97 appropriations. The report recommended that the DFAS Indianapolis Center document the process for receiving, adjusting, and consolidating the general ledger trial balances received from accounting offices. DFAS concurred with the recommendation.

Appendix D. Laws and Regulations Reviewed

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

Public Law 103-356, "Federal Financial Management Act of 1994," October 13, 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 10, 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

Treasury Retention Bulletin No. 97-06, "Year-End Closing," July 24, 1997

Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," March 30, 1993

DoD 7000.14-R, "DoD Financial Management Regulation," volume 6, "Reporting Policy and Procedures," Chapter 6, "Form and Content of Audited Financial Statements," 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 1, "General Financial Management Information and Requirements," May 1993

Appendix E. Report Distribution

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Other Defense Organizations

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Director, Defense Finance and Accounting Service
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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

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