INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR EXPENSE ACCOUNT LINE ITEMS ON THE FY 1996 DEFENSE BUSINESS OPERATIONS FUND CONSOLIDATED FINANCIAL STATEMENTS

Report No. 98-086

March 4, 1998

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Acronyms

AAA Army Audit Agency
AFAA Air Force Audit Agency
DBOF Defense Business Operations Fund
DFAS Defense Finance and Accounting Service
GLAC General Ledger Account Code
IG Inspector General
NAVAUDSVC Naval Audit Service
OMB Office of Management and Budget
USD(C) Under Secretary of Defense (Comptroller)
MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) 
AND CHIEF FINANCIAL OFFICER 
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE 

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and 
Regulations for Expense Account Line Items on the FY 1996 Defense 
Business Operations Fund Consolidated Financial Statements 
(Report No. 98-086) 

We are providing this report for your information and use. Financial statement 
audits are required by the Chief Financial Officers Act of 1990, as amended by the 
Government Management Reform Act of 1994. The information in this report was 
used in disclaiming an opinion on the Defense Business Operations Fund consolidated 
financial statements for FY 1996 and in evaluating the adequacy of internal controls 
and compliance with laws and regulations. This is the fourth and final report in a 
series of reports dealing with Defense Business Operations Fund expense issues for 
FY 1996. The issues identified in this report are equally applicable to future Working 
Capital Fund financial statements.

We provided you with a draft of this report on November 26, 1997. Because 
the report contains no recommendations, written comments were not required, and 
none were received.

We appreciate the courtesies extended to the audit staff. Questions on the audit 
should be directed to Mr. Richard B. Bird, Audit Program Director, at (703) 604-9175 
(DSN 664-9175 or e-mail RBird@DODIG.OSD.MIL) or Mr. Carmelo G. Ventimiglia, 
Audit Project Manager, at (317) 510-3852 (DSN 699-3852 or e-mail 
CVentimiglia@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
Executive Summary


In auditing the DBOF consolidated financial statements for FY 1996, our approach was to evaluate selected financial statement accounts. One of the accounts was DBOF expenses. This report summarizes the reportable conditions on internal controls and compliance with laws and regulations related to DBOF expenses. The Military Department audit organizations provided assistance in identifying internal control weaknesses and areas of noncompliance with laws and regulations for the expense accounts line items. Expense account line items totaled $76.4 billion on the FY 1996 DBOF consolidated financial statements.

In December 1996, the Under Secretary of Defense (Comptroller) announced that the DBOF would be eliminated and separate working capital funds would be established. Under the working capital fund concept, each of the DoD Components will be responsible for managing the functional and financial aspects of their support functions and activities and retain their individuality in managing operations. This restructuring does not materially affect the issues discussed in this report.

This is the fourth and final in a series of reports dealing with DBOF expense issues for FY 1996. See Appendix B for details of these reports.

Audit Objectives. The primary audit objective was to determine whether the expenses on the FY 1996 DBOF consolidated financial statements were presented fairly in accordance with Office of Management and Budget Bulletin No. 94-01, “Form and Content of Agency Financial Statements,” November 16, 1993. In addition, we determined whether controls were adequate to ensure that the consolidated financial statements were free of material error. We also assessed compliance with selected laws and regulations for transactions and events that have a direct and material effect on the expense accounts on the financial statements. Additionally, we followed up on conditions related to expenses in previous audits of the DBOF financial statements.
Internal Controls. A sound internal control structure had not been established to record and report expenses on the FY 1996 DBOF consolidated financial statements. Material internal control weaknesses, such as inadequate accounting systems, identified in Inspector General, DoD, Report No. 97-178, “Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1996,” June 26, 1997, adversely affected the fair presentation of all account balances, including expenses. Weaknesses in controls over recording and reporting expenses also caused material misstatements in the expense account line item balances. We could not determine whether all misstatements were identified, and whether account balances were fair and reasonable. If internal control weaknesses are not corrected, future financial statements will continue to be materially misstated. Part I.A. contains our report on internal controls.

Compliance With Laws and Regulations. Noncompliance with laws and regulations materially affected the reliability of the data reported for expenses on the FY 1996 DBOF consolidated financial statements. Systems of accounting and internal controls did not completely or accurately disclose the results of operations of the activities of the DBOF as required by Title 31, United States Code. We also identified instances of noncompliance with DoD 7000.14-R, “DoD Financial Management Regulation.” If these instances of noncompliance are not corrected, the reliability of data reported for expenses will materially affect the financial statements for FY 1997 and beyond. Part I.B. contains our report on compliance with laws and regulations. Appendix C lists the laws and regulations tested.

Followup on Previously Reported Issues. Overall, progress was made in correcting previously identified problems. However, a significant problem related to the fair presentation of expenses is the continued need for the Office of the Under Secretary of Defense (Comptroller) and Headquarters, Defense Finance and Accounting Service, to ensure that financial reports and statements are prepared in compliance with DoD and Office of Management and Budget guidance.

Summary of Recommendations. The Inspector General, DoD, and the supporting Military Department audit organizations made specific recommendations in prior reports. See Appendix B for a listing of those reports. Accordingly, we are making no further recommendations.

Management Comments. We provided management a draft of this report on November 26, 1997. Because this report contains no recommendations, written comments were not required, and none were received. Therefore, we are publishing this report in final form.
# Table of Contents

**Executive Summary**  

<table>
<thead>
<tr>
<th>Part I - Audit Results</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Background</td>
<td>2</td>
</tr>
<tr>
<td>Audit Objectives</td>
<td>3</td>
</tr>
</tbody>
</table>

**Part I.A. - Review of Internal Control Structure**  

| Introduction          | 6 |
| Reportable Conditions | 7 |

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

| Introduction          | 12 |
| Reportable Conditions | 12 |
| Compliance With Laws  | 12 |
| Compliance With Regulations | 13 |

**Part II - Additional Information**  

<table>
<thead>
<tr>
<th>Appendix A. Audit Process</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope</td>
<td>20</td>
</tr>
<tr>
<td>Methodology</td>
<td>22</td>
</tr>
<tr>
<td>Appendix B. Summary of Prior Coverage</td>
<td>24</td>
</tr>
<tr>
<td>Appendix C. Laws and Regulations Reviewed</td>
<td>28</td>
</tr>
<tr>
<td>Appendix D. Summary of Work Performed</td>
<td>30</td>
</tr>
<tr>
<td>Appendix E. Report Distribution</td>
<td>33</td>
</tr>
</tbody>
</table>
Part I - Audit Results
Audit Background

The Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994, requires annual audited financial statements for revolving funds such as the Defense Business Operations Fund (DBOF). Office of Management and Budget (OMB) Bulletin No. 93-06, “Audit Requirements for Federal Financial Statements,” January 8, 1993, requires the Inspector General (IG), DoD, to render an opinion on the financial statements and report on the adequacy of internal controls and compliance with laws and regulations. The IG, DoD, used an account approach to audit the DBOF consolidated financial statements for FY 1996. One of the accounts was DBOF expenses. The accuracy of other accounts on the financial statements, such as inventory and plant, property, and equipment, can also significantly impact the presentation of the $76.4 billion of expense account line items.

This is the fourth and final in a series of reports dealing with DBOF expense issues for FY 1996. See Appendix B for details of these reports.

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

Statement of Operations. Preparation of the financial statements is the responsibility of the Defense Finance and Accounting Service (DFAS). The DoD Components and DFAS are jointly responsible for the information in the statements. The Statement of Operations (and Changes in Net Position), referred to as the Statement of Operations, is the DBOF financial statement that compares revenues and expenses for the reporting period. Expenses are classified and reported on specific line items in the Statement of Operations. Controls over transactions supporting expense account line items are necessary
to ensure that the accounts are free from material error. Compliance with laws and regulations provides greater assurance that the financial statements are free of material misstatements.

**Previously Identified Problems.** As the IG, DoD, has reported in previous DBOF reports and the USD(C) has acknowledged in his management representation letter, dated April 9, 1997, a sound internal control structure for the DBOF has not been established and noncompliance with laws and regulations continues to materially affect the reliability of the DBOF consolidated financial statements. IG, DoD, Report No. 97-178, “Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1996,” June 26, 1997, states that an opinion could not be rendered on the FY 1996 DBOF consolidated financial statements because of the lack of a sound internal control structure and significant deficiencies in accounting systems.

**Audit Objectives**

The primary audit objective was to determine whether the expenses on the FY 1996 DBOF consolidated financial statements were presented fairly in accordance with OMB Bulletin No. 94-01, “Form and Content of Agency Financial Statements,” November 16, 1993. In addition, we determined whether controls were adequate to ensure that the consolidated financial statements were free of material error. We also assessed compliance with selected laws and regulations for transactions and events that have a direct and material effect on the financial statements. Additionally, we followed up on conditions related to expenses in previous audits of the DBOF financial statements. Part I.A. contains our report on internal controls. Part I.B. contains our report on compliance with laws and regulations. Appendix A provides the scope and methodology, auditing standards, and accounting principles. Appendix B provides a summary of prior audit coverage.
Part I.A. - Review of Internal Control
Structure
Introduction

Audit Responsibilities. Our audit objective was to determine whether controls over transactions supporting general ledger accounts used to compute expense account line items in the FY 1996 DBOF Consolidated Statement of Operations were adequate to ensure that the line items were free of material error. In planning and performing our audit of the DBOF expense accounts for the year ending September 30, 1996, we evaluated the internal control structure. We performed this evaluation to:

- identify the auditing procedures necessary to determine whether the expense account line items on the Statement of Operations were free of material error, and
- determine whether an internal control structure had been established.

That determination included obtaining an understanding of the internal control policies and procedures, as well as assessing the level of control risk relevant to significant cycles, classes of transactions, and account balances. For those significant control policies and procedures that were properly designed and placed in operation, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed. For areas where internal controls were determined to be weak, we performed tests to determine the level of assurance that could be placed on those controls.

Management Responsibilities. DBOF management was responsible for establishing and maintaining an internal control structure. In fulfilling that responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies and procedures. The Office of the USD(C) and the Corporate Board set overall policy for the DBOF, and the Military Departments and Defense agencies are responsible for management and operations. An internal control structure should 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 that could have a direct and material effect on the consolidating statements, including those related to obligations and costs, are executed in compliance with laws and regulations directly related to the
Review of Internal Control Structure

statements and with any other laws and regulations that the OMB, entity management, or the IG, DoD, have identified as being significant and for which compliance can be objectively measured and evaluated.

**Internal Control Structure.** The three elements of the control structure are the control environment, accounting and related systems, and control procedures. The control environment is the collective effort of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include management's philosophy and operating style, the entity's organizational structure, and personnel policies and practices. The control environment reflects the overall attitude, awareness, and actions of management concerning the importance of control and emphasis placed on it within the entity. Accounting and related systems are the 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, which management has established to provide reasonable assurance that specific objectives will be achieved.

**Reportable Conditions**

We examined the internal control structure for recording and reporting DBOF expenses for the year ending September 30, 1996. Our review of DBOF internal controls disclosed material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. We also identified conditions that we considered to be reportable under OMB Bulletin No. 93-06. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure 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 the internal control structure does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited and would not be detected in a timely manner by employees in the normal course of performing their functions.

**Overall Conditions Noted.** Internal controls for the DBOF expense accounts were not adequate. Material internal control weaknesses existed in the areas of

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

edit controls in automated systems, crosswalks, supporting documentation, reporting military personnel costs, and inventory valuation. Because of inadequacies in the internal control structure, we could not determine whether the amounts reflected all errors; therefore, we could not determine whether account balances were fair and reasonable.

Table 1 summarizes the major internal control deficiencies related to DBOF expenses and the corresponding impact on the FY 1996 DBOF consolidated financial statements.

<table>
<thead>
<tr>
<th>Issue</th>
<th>Impact</th>
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<tbody>
<tr>
<td>Edit controls in automated systems</td>
<td>Inadequate edit controls in Air Force depot accounting and logistics systems caused the Purchases at Standard Price account to be overstated by $763.6 million and the Inventory at Repair Contractors account to be overstated by $711 million. Auditors could not validate $9.6 billion in transactions charged to the Purchases at Standard Price account due to the amount and nature of the errors identified.</td>
</tr>
<tr>
<td>Crosswalks</td>
<td>DFAS Denver Center overstated Cost of Goods Sold for Air Force Supply Management by including $4.7 billion in prior period adjustments as FY 1996 expenses.</td>
</tr>
<tr>
<td>Supporting documentation</td>
<td>Documentation was not available to support $60.3 billion in adjusting journal vouchers made by the DFAS Denver Center.</td>
</tr>
<tr>
<td>Reporting military personnel costs</td>
<td>Air Mobility Command did not establish procedures to accumulate and report $512 million in military personnel costs.</td>
</tr>
<tr>
<td>Inventory valuation</td>
<td>Army DBOF Cost of Goods Sold was overstated by $1.2 billion as a result of an attempt to correct a previously identified problem.</td>
</tr>
</tbody>
</table>

Edit Controls in Automated Systems. Air Force depot accounting and logistics systems did not have adequate edit controls to correctly record purchases and nonpurchase receipt transactions into the Supply Management business area general ledger accounts. Information from the depot logistics system did not contain sufficient contract information to correctly classify receipt transactions. Consequently, the depot accounting system improperly recorded receipts from repair contractors as purchases. This misclassification overstated the Purchases at Standard Price account by $763.6 million and the Inventory at Repair Contractors account by $711 million. Because of the amount and nature of the incorrect classifications of inventory receipts, Air Force Audit Agency personnel could not validate $9.6 billion in transactions charged to the Purchases at Standard Price account in their
FY 1996 audit. The depot accounting system recorded purchases in the Purchases at Standard Price account for an item’s sale price and the Purchases at Cost account for the actual amount paid for an item. The Purchases at Cost and the Inventory at Repair Contractors accounts are used in computing the Cost of Goods Sold, a major expense account line item on the Statement of Operations.

**Crosswalks.** The DoD standard general ledger accounts have not been incorporated into all accounting systems that support DBOF. Errors sometimes occurred when Service-unique general ledger accounts were crosswalked to DoD standard general ledger accounts. For example, in preparing the FY 1996 DBOF Statement of Operations in the Air Force Supply Management business area, DFAS Denver Center erroneously crosswalked $4.7 billion in Air Force general ledger account code (GLAC) 341.15, Prior Period Adjustments, to DoD standard GLAC 7291.3, Inventory Losses or Adjustments. By doing so, the DFAS Denver Center included $4.7 billion in prior period adjustments in the calculation of Cost of Goods Sold on the FY 1996 Statement of Operations. The DFAS Denver Center appropriately adjusted version 3 of the FY 1996 Statement of Operations by moving the $4.7 billion from the calculation of Cost of Goods Sold to Prior Period Adjustments. The adjusted statement was included in the FY 1996 DBOF consolidated financial statements. Many of the adjustments made by the DFAS Denver Center in preparing the FY 1996 Statement of Operations attempted to correct crosswalk problems that affected expenses.

**Supporting Documentation.** The DFAS Denver Center misrepresented the expenses and the results of operations for the Air Force Supply Management business area in the FY 1996 DBOF Statement of Operations. This condition occurred because effective procedures had not been developed to ensure that adjustments made to the financial data received from field accounting organizations were supported and proper. Further, the DFAS Denver Center personnel did not follow established guidance in presenting the financial data after they made the adjustments. Because of the lack of supporting documentation for 13 adjustments totaling $60.3 billion and weaknesses in controls over presenting expenses and other financial data, the operating gain of $2.2 billion and the $10.6 billion in expenses reported in FY 1996 for the Air Force Supply Management business area were subject to a high risk of material misstatement.

**Reporting Military Personnel Cost.** Air Mobility Command personnel had not established internal control procedures to accumulate and report the cost of authorized and assigned military personnel performing Airlift Services Division duties so that they could report the civilian-equivalent cost of military personnel in expense accounts. Air Mobility Command personnel did not record FY 1996 authorized military personnel costs totaling $496 million in Airlift Services Division expense accounts. Further, expenses were not increased by $16 million to reflect the assignment of more military personnel than authorized.
Inventory Valuation. DFAS Indianapolis Center personnel did not correct a previously identified problem. During FY 1995, the Army Audit Agency reported that Inventory, Net, was understated by $1.2 billion. DFAS Indianapolis Center made a monthly adjustment reducing the value of Army DBOF unserviceable, reparable inventory by its estimated repair costs. However, these costs were already included in the inventory allowance account. Therefore, when inventory was presented in the net of the allowance account on the Army DBOF financial statements, the value had been reduced twice for estimated repair costs. The understated inventory amount also caused Cost of Goods Sold to be overstated by $1.2 billion for FY 1995 and Net Operating Results (which carried over to Accumulative Operating Results) to be understated by the same amount. During FY 1996, DFAS Indianapolis Center personnel made an accounting entry to correct the understatement of Accumulative Operating Results by making a prior period adjustment. However, the understated beginning inventory balance for FY 1996 was not adjusted, causing Cost of Goods Sold to be understated.

Summary. Problems continue to exist in the internal control structure for recording and reporting expenses. If internal control weaknesses are not corrected, Working Capital Fund financial statements will continue to be materially misstated.
Part I.B. - Review of Compliance With Laws and Regulations
Introduction

We evaluated the DBOF expense accounts for material instances of noncompliance with laws and regulations for the year ending September 30, 1996. Our audit objective was to assess compliance with laws and regulations for those transactions and events that have a direct and material effect on the financial statements. Such tests are required by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994. We reviewed compliance with selected laws and regulations related to DBOF expenses to obtain reasonable assurance that reported expenses on the financial statements were free of material misstatements, not to render an opinion on overall compliance with such provisions. IG, DoD, Report No. 97-178, "Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1996," June 26, 1997, states that we were unable to render an opinion in the DBOF consolidated financial statements. See Appendix C for a list of the laws and regulations reviewed.

The Deputy Secretary of Defense, the USD(C), the Secretaries of the Military Departments, the directors of affiliated DoD agencies, and the Director, DFAS, are responsible for ensuring compliance with laws and regulations applicable to the DBOF. As part of obtaining reasonable assurance that the Statement of Operations is free of material misstatements, we tested compliance with selected laws and regulations that may directly affect the expenses on the Statement of Operations and with other laws and regulations designated by the OMB and the DoD.

Reportable Conditions

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.

Compliance With Laws

Noncompliance with laws materially affected the reliability of the DBOF financial statements. We were unable to determine, through audit tests and procedures, the range and magnitude of noncompliance with the laws identified
Review of Compliance With Laws and Regulations

in Appendix C of this report. Weak internal controls and insufficient audit trails for transactions prevented us from obtaining sufficient information to fulfill this objective.

The systems of accounting and internal controls for the DBOF did not completely or accurately disclose the results of operations of the DBOF organizations as required by Title 31, United States Code. Weaknesses in DoD accounting systems have been reported since the inception of DBOF. DoD accounting systems do not comply with Federal and DoD requirements. Because of inadequacies in the DBOF internal control structure and accounting systems, no assurance exists that expense transactions are accurately and reliably accounted for and reported. We are working with the USD(C) to establish integrated accounting systems and improve internal controls to ensure compliance with fiscal statutes.

Compliance With Regulations

Widespread noncompliance with regulations materially affected the reliability of the DBOF financial statements. We were unable to determine, through audit tests and procedures, the range and magnitude of noncompliance with the expense-related portions of the regulations identified in Appendix C of this report.

Table 2 illustrates instances of noncompliance with regulations and the corresponding dollar effect (if any) on the expense account line items of the FY 1996 DBOF consolidated financial statements.
### Table 2. Instances of Noncompliance With Regulations Related to DBOF Expenses

<table>
<thead>
<tr>
<th>Compliance Issue</th>
<th>Impact</th>
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<tbody>
<tr>
<td>Establishing allowance accounts</td>
<td>The Defense Logistics Agency did not establish inventory allowance accounts so that gains and losses could be reported in the proper periods and Cost of Goods Sold could be computed correctly.</td>
</tr>
<tr>
<td>Calculating Cost of Goods Sold</td>
<td>DFAS Denver Center overstated the Cost of Goods Sold by including $3.2 billion of Depot-Level Reparable Exchange Credits twice.</td>
</tr>
<tr>
<td>Accounting for discounts</td>
<td>The DFAS Columbus Center overstated Cost of Goods Sold by $15.6 million for Defense Commissary Agency because discounts earned on purchases of goods acquired for resale were not accounted for properly.</td>
</tr>
<tr>
<td>Recording expenses</td>
<td>DBOF organizations did not record $414 million in expenses to cover disbursements that had not been promptly matched to corresponding obligations in accounting records.</td>
</tr>
<tr>
<td>Implementing depreciation guidance</td>
<td>Army depot maintenance organizations did not have a financial system in place to compute depreciation expense for individual buildings.</td>
</tr>
<tr>
<td></td>
<td>Navy DBOF expenses were understated by $4.6 million because two commands misinterpreted guidance and directed organizations to not report depreciation for selected assets.</td>
</tr>
<tr>
<td></td>
<td>The accuracy of depreciation expenses in the Air Force Depot Maintenance business area could not be determined because organizations did not comply with the requirement to maintain and reconcile subsidiary ledgers for all property account balances.</td>
</tr>
<tr>
<td></td>
<td>Additional actions are needed to identify and report all capital assets used by Defense agencies so that depreciation expenses can be computed accurately.</td>
</tr>
<tr>
<td>Conflicting guidance</td>
<td>The DFAS Centers did not consistently calculate and present expense account line items in the individual Statement of Operations because of conflicting OMB and DoD guidance resulting in $441 million of expenses being misclassified.</td>
</tr>
</tbody>
</table>

**Establishing Allowance Accounts.** The Defense Logistics Agency did not establish allowance accounts for inventory holding gains and losses as required by DoD 7000.14-R, “DoD Financial Management Regulation,”
Review of Compliance With Laws and Regulations

volume 11B, "Reimbursable Operations, Policy and Procedures—Defense Business Operations Fund," December 1994. DoD 7000.14-R, volume 11B, requires that inventory be reported on the financial statements at the latest acquisition cost, minus an Allowance for Unrealized Holding Gains and Losses account. The Defense Logistics Agency records inventory at latest acquisition cost; however, inventory gains and losses are recognized in the current period, not when the inventory is sold. This method could overstate or understate the inventory values because the gains and losses on the inventory were not reported in the proper period. The Cost of Goods Sold would be misstated by the amount that should be in the allowance account for the unsold inventory.

Calculating Cost of Goods Sold. The DFAS Denver Center did not follow "DoD Guidance on Form and Content of Financial Statements for FY 1996 Financial Activity," October 1996 (DoD Form and Content Guidance for FY 1996), and DoD 7000.14-R, volume 11B, for calculating Cost of Goods Sold. For example, the DFAS Denver Center overstated the Cost of Goods Sold by $3.2 billion in version 3 of the FY 1996 DBOF Statement of Operations in the Air Force Supply Management business area because depot-level repayable exchange credits were included both as Customer Returns—Credit Given and Depot-Level Reparable Exchange Credits. The DFAS Denver Center appropriately adjusted version 3 of the FY 1996 Statement of Operations by removing $3.2 billion from Customer Returns—Credit Given. The adjusted statement was included in the FY 1996 DBOF consolidated financial statements.

Accounting for Discounts. The DFAS Columbus Center did not follow DoD guidance in accounting for discounts earned on purchases of goods acquired for resale by the Defense Commissary Agency. As a result, the expenses on the FY 1996 DBOF Statement of Operations were overstated by $15.6 million.

Recording Expenses. DBOF organizations did not record $414 million in expenses to cover disbursements that had not been promptly matched to corresponding obligations in accounting records in accordance with guidance issued by the USD(C) in June 1995. That guidance was subsequently included in DoD 7000.14-R, volume 3, "Budget Execution—Availability and Use of Budgetary Resources," December 1996. The guidance requires that administrative obligations and expenses be established for disbursements that have not been matched to the correct obligations within 180 days of the dates of the disbursements. As of September 30, 1996, DFAS reported that DBOF organizations had $414 million in unmatched disbursements and negative unliquidated obligations that had not been correctly matched to corresponding obligations in accounting records or for which no pending correction existed.

Implementing Depreciation Guidance. The Military Departments and Defense agencies did not comply with guidance for depreciating property, plant, and equipment. The cost of property, plant, and equipment should be recognized through depreciation of the asset over the expected useful life of the asset. Problems with the reporting process for property, plant, and equipment makes computing depreciation expense difficult.
Review of Compliance With Laws and Regulations

Army. Army depot maintenance activities did not have a financial system that allowed them to compute depreciation for individual buildings. DoD 7000.14-R, volume 4, "Accounting Policy and Procedures," January 1995, requires activities to depreciate buildings individually. Army Audit Agency first reported this problem as part of the audit of the FY 1992 financial statements. Since that time, DoD has designed the Defense Property Accountability System as the standard DoD system to account for and depreciate real property. A DoD-level Real Property Integrated Process Team is working on policy and procedures to ensure accurate data is loaded into the Defense Property Accountability System. All working capital fund organizations are scheduled to have the new Defense Property Accountability System by the end of FY 2000.

Navy. Navy DBOF records for property, plant, and equipment were inaccurate because the Naval Sea Systems Command and the Naval Air Systems Command directed at least nine closing facilities not to report depreciation for selected assets. Naval Audit Service identified unrecorded depreciation totaling $4.6 million at one of the facilities. Naval Audit Service did not quantify the understatement of depreciation expense at the other eight facilities. This condition occurred because the two commands misinterpreted guidance and advised their closing facilities to stop reporting depreciation on assets that were not going to be transferred to other DBOF organizations.

Air Force. Air Force Materiel Command personnel did not possess comprehensive control listings (subsidiary ledgers) that accurately summarized and reconciled to the property, plant, and equipment balances recorded in the general ledger control accounts in the Depot Maintenance business area. As a result, the control account balances were either unsupported or varied substantially from existing subsidiary records. For example, the Air Force Materiel Command could not provide subsidiary ledgers for eight individual equipment accounts at two Air Logistics Centers. Also, the civil engineering records that Air Force Materiel Command personnel identified as the subsidiary ledgers for the facilities-in-use control account totaled $1.5 billion more than the general ledger control account balance. These conditions occurred because the organizations within the Depot Maintenance business area did not comply with the requirement in DoD 7000.14-R, volume 1, "General Management Information, Systems, and Requirements," May 1993, to maintain and reconcile subsidiary ledgers supporting for all property account balances. In addition, Air Force Materiel Command personnel did not validate that organizations complied with established policy. Consequently, the accuracy of the related depreciation expenses for FY 1996 could not be accurately determined.

Defense Agencies. The Defense Logistics Agency made significant progress toward correcting problems previously reported on capitalization and reporting of property, plant, and equipment. However, additional actions are needed. For example, the financial information used to report $1.6 billion of property, plant, and equipment on the Defense Logistics Agency's FY 1995 financial statements was understated by at least $422.3 million. This understatement also adversely affected the FY 1996 financial statements. Additional problems were identified at the Defense
Commissary Agency, which did not properly capitalize and report in the appropriate financial statements the costs of property, plant, and equipment used in its operations. When the property, plant, and equipment used by DBOF organizations is not correctly identified and reported, depreciation expenses cannot be computed accurately.

**Conflicting Guidance.** The DFAS centers did not consistently calculate and present expense account line items in the individual FY 1995 Statements of Operations prepared for DBOF reporting entities in the Supply Management business area. The lack of uniformity in reporting occurred because of conflicting guidance among OMB Bulletin No. 94-01; “DoD Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity,” as amended on November 27, 1995; and DoD 7000.14-R, volume 11B. In addition, personnel in the Office of the USD(C) and Headquarters, DFAS, did not effectively monitor the reporting of expenses to ensure that financial reports and statements were prepared in compliance with OMB and DoD guidance. Followup work showed that two organizations continued to use outdated guidance in DoD 7000.14-R, volume 11B, in preparing the FY 1996 Statement of Operations. This caused $441 million in expenses to be misclassified.

**Summary.** Noncompliance with regulations continued to be a major DBOF issue. Noncompliance issues related to expenses include the failure to correctly compute Cost of Goods Sold and record depreciation. Although progress has been made in addressing problems previously reported by the IG, DoD, and the Military Department audit organizations, noncompliance will continue to prevent opinions from being expressed on the Working Capital Fund financial statements until the responsible organizations take corrective action on major issues related to expenses and other accounts.
Part II - Additional Information
Appendix A. Audit Process

Scope

**Statements Reviewed.** We examined the expense account line items on the DBOF consolidated financial statements for the year ending September 30, 1996.

The IG, DoD, used an account approach to audit the FY 1996 DBOF consolidated financial statements. One of the accounts was DBOF expenses. Expense account line items totaled $76.4 billion on the FY 1996 DBOF Consolidated Statement of Operations. We coordinated our audit efforts with the Military Department audit organizations (the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency). The IG, DoD, and the Military Department audit organizations evaluated internal controls and reviewed transactions related to selected general ledger accounts that made up the material expense account line items in major business areas. Appendix D identifies the business areas in which work was performed. We also evaluated the procedures followed by the DFAS Denver Center to present expense accounts on the FY 1996 Statement of Operations for the DBOF Air Force Supply Management business area. Our combined audit efforts provide a reasonable basis for our results.

**Auditing Standards.** We conducted our audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States (the Comptroller General), as implemented by the IG, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Statements are free of material misstatements. The Statement of Operations is one of the Principal Statements. We relied on the guidelines suggested by the General Accounting Office and our professional judgment in assessing the materiality of matters affecting the fair presentation of financial statements and related internal control weaknesses.

**Accounting Principles.** The Federal Accounting Standards Advisory Board (the Board) was established to consider and recommend accounting standards and principles for the Federal Government to improve the usefulness of Federal financial reports. The Board's principals are the Director, OMB; the Secretary of the Treasury; and the Comptroller General. When the Board's principals adopt them, the recommendations are published and form the body of standards that are considered Federal generally accepted accounting principles.

To date, eight accounting standards and two accounting concepts have been published in final form, and three accounting standards have been published in
Appendix A. Audit Process

draft form. These standards and concepts are incorporated in OMB guidance for use by Federal agencies in preparing financial statements. Through FY 1996, agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 94-01, as follows:

- standards agreed to and published;
- form and content requirements of OMB Bulletin No. 94-01;
- accounting standards contained in agency accounting policy guidance as of March 29, 1991; and
- accounting principles published by other authoritative sources.

Beginning in FY 1997, agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, “Form and Content of Agency Financial Statements,” October 16, 1996, as follows:

- standards agreed to by the Director, OMB; the Secretary of the Treasury; and the Comptroller General;
- interpretations on the standards issued by OMB;
- requirements of the effective OMB form and content bulletin; and
- accounting principles published by other authoritative sources.

Because only three accounting standards and two accounting concepts were effective in FY 1996, most accounting standards for the “other comprehensive basis of accounting” used by DoD came from DoD 7220.9-M, “Accounting Manual,” June 17, 1991, as the primary DoD accounting guidance. Since FY 1992, the USD(C) has updated sections of DoD 7220.9-M and has incorporated those sections into new volumes of DoD 7000.14-R, “DoD Financial Management Regulation.” The USD(C) has issued 15 completed volumes as of April 1997. DoD 7000.14-R will be the single DoD-wide regulation used by DoD Components for accounting, budgeting, finance, and financial management training. However, after FY 1996, neither DoD 7220.9-M nor DoD 7000.14-R will be the authoritative basis for preparing financial statements.

Audit Assistance. We relied on audit assistance from the Army Audit Agency (AAA), the Naval Audit Service (NAVAUDSVC), and the Air Force Audit Agency (AFAA). The information in this report is a summary of the most significant deficiencies reported by the IG, DoD, and the Military Department audit organizations. Appendix D identifies the audit reports in which the detailed audit results can be found.

Scope of Review of Internal Controls. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements, including the accompanying notes. An audit also includes assessing the
Appendix A. Audit Process

accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements. Previous audits by
the IG, DoD, disclosed an inadequate internal control structure along with
significant deficiencies with the accounting systems within the DBOF. This
inadequate control structure and system deficiencies precluded us from placing
reliance on internal controls or rendering an opinion on the consolidated
financial statements in previous years. Therefore, we revised our planned audit
work to focus on reviewing internal controls in more detail. In support of the
overall audit of the FY 1996 DBOF consolidated financial statements, we
reviewed internal controls related to expenses on the FY 1996 DBOF
Consolidated Statement of Operations.

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

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

We did not review management's implementation of DoD Directive 5010.38,*
"Internal Management Control Program," April 14, 1987, because of the lack
of a sound internal control structure within the DBOF. We revised our audit
approach accordingly to focus on specific internal controls for DBOF expenses.

Management Representation Letter. We received a management
representation letter from the USD(C), dated April 9, 1997, regarding the
FY 1996 DBOF consolidated financial statements. The letter cites major
deficiencies in accounting systems, internal control weaknesses, and compliance
problems that affect many DBOF accounts, including expenses.

Methodology

Computer-Processed Data. Based on management's representation and on the
audit work that we performed along with the Military Department audit

*DoD Directive 5010.38 has been revised as "Management Control Program,"
August 26, 1996. The audit was performed under the April 1987 version of the
Directive.
organizations, we concluded that computer-processed data were not completely reliable. For evaluations of the DBOF entities' computer-processed data, refer to the reports of the audit organizations listed in Appendix B.

Audit Type, Dates, and Locations. This financial-related audit was conducted from January 1996 through November 1997 at offices of the USD(C) and DFAS and within the business areas of the Military Departments and Defense agencies that are part of DBOF.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD. Further details are available on request.
Appendix B. Summary of Prior Coverage

The IG, DoD, issued three reports specifically dealing with DBOF expense issues. Two IG, DoD, reports on the DBOF consolidated financial statements identified issues that affect the fair presentation of all account balances, including expenses. The Military Department audit organizations also issued reports related to DBOF expense issues.

Reports Dealing With DBOF Expense Issues

IG, DoD, Report No. 98-056, “Controls Over Presenting Expense Account Line Items on the FY 1996 Statement of Operations for the Air Force Supply Management Business Area,” January 27, 1998. This report states that the DFAS Denver Center misrepresented the expenses and results of operations on the FY 1996 DBOF Air Force Supply Management Statement of Operations. Problems occurred because sufficient controls were not in place and working to ensure that changes made to field-level data were supported and proper. Further, the presentation of the financial data after the changes were made did not follow established guidance. The report recommended that the DFAS Denver Center verify the accuracy of the crosswalk used to transfer data in the Air Force Supply Management business area general ledger accounts to the DoD general ledger accounts. The report also recommended that the DFAS Denver Center restate the financial information related to the FY 1996 DBOF Air Force Supply Management business area in the FY 1997 Air Force Working Capital Fund financial statements to reflect needed changes to line 10, Cost of Goods Sold, and line 14, Other Expenses. We did not receive management comments to our draft report and requested that the Director, DFAS Denver Center, provide comments to the final report.

Report No. 97-223, “Recording and Reporting Expenses of the Defense Commissary Agency,” September 30, 1997. This report states that internal controls over the recording and reporting of certain expenses were generally adequate. However, Defense Commissary Agency personnel in four of the six regions located in the continental United States did not properly record and report expenses on annual agreements and contracts for services. In addition, DFAS Columbus Center personnel did not follow DoD guidance in accounting for discounts earned on purchases of goods bought for resale. As a result, the expenses on the FY 1996 Statement of Operations were overstated by at least $16.1 million. The report recommended that the Resource Management Directorate of each region obtain as soon as possible after the end of each month the receiving reports needed to record expenses related to annual agreements and contracts for services. The Defense Commissary Agency concurred with the recommendation and issued a memorandum to the Resource Management Directorate of each region instructing them to promptly obtain the receiving reports needed to record expenses related to annual agreements and
contracts for services. The report also recommended that the Director, DFAS Columbus Center, accumulate discounts earned on purchases in GLAC 6500.1G, Cost of Goods Sold—Inventory Gains—Discounts Earned, and include them in calculating the cost of goods sold. The DFAS Deputy Director for Accounting did not agree to reduce the cost of goods sold by the cumulative amount of discounts earned on purchases, stating that the accounting for the movement of funds as a result of the discounts earned must be balanced between the Commissary Resale Stock Fund and the Commissary Surcharge Collections Fund. DFAS also stated that a footnote on the Accounting Report 1307 provides full disclosure of the accounting practice used by Defense Commissary Agency in transferring the discounts between the two funds. However, we continue to believe that DFAS Columbus Center should accumulate discounts earned on purchases in GLAC 6500.1G, Cost of Goods Sold—Inventory Gains—Discounts Earned, and include them in calculating the cost of goods sold. Continuing to transfer the discounts earned overstates the revenues on the Commissary Surcharge Collections Fund and also overstates the expenses on the Commissary Resale Stock Fund. The Defense Commissary Agency consolidated financial statements did not contain a footnote disclosing the accounting practice. The report is in mediation.

IG, DoD, Report No. 97-062, “Consistency in Reporting the Expenses Account Line Items of the Defense Business Operations Fund,” January 7, 1997. This report states that the DFAS Centers did not consistently calculate and present expense account line items in the individual FY 1995 Statements of Operations that they prepared for DBOF reporting entities in the Supply Management business area. As a result, of the $80.1 billion of expense account line items on the individual Statements of Operations, at least $1.6 billion of the $47 billion that we reviewed was misclassified, thus preventing an accurate consolidation of DBOF financial information. The lack of uniformity in reporting occurred because of conflicting guidance among OMB Bulletin No. 94-01; DoD Form and Content Guidance for FY 1996; and DoD 7000.14-R, volume 11B. In addition, personnel in the Office of the USD(C) and Headquarters, DFAS, had not appropriately monitored how the DFAS Centers used data provided by reporting entities in calculating and presenting expense account line items. The report recommended that the USD(C) revise DoD 7000.14-R, volume 11B, and update DoD Form and Content Guidance for FY 1996 to correct inconsistencies with the guidance in OMB Bulletin No 94-01. DoD Form and Content Guidance for FY 1996 was updated to correct the conflicts, but changes to DoD 7000.14-R, volume 11B, have not yet been issued. Subsequent followup on the FY 1996 Statements of Operations showed that two organizations continued to use the guidance in DoD 7000.14-R, volume 11B, in preparing the Statement of Operations. By following the guidance in DoD 7000.14-R, volume 11B, $441 million in expenses was misclassified. The Deputy Chief Financial Officer agreed to review the methodologies used by the DBOF reporting entities and the DFAS Centers through periodic working sessions.
Appendix B. Summary of Prior Coverage

Consolidated DBOF Report Summaries

IG, DoD, Report No. 97-178, “Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1996,” June 26, 1997. This report states that the IG, DoD, was unable to render an opinion on the DBOF consolidated financial statements for FY 1996. As reported in previous DBOF reports and acknowledged in the USD(C) management representation letter, a sound internal control structure had not been established. Material internal control weaknesses, such as inadequate accounting systems and lack of policy and procedures, identified in previous DBOF reports still exist. Noncompliance with laws and regulations continued to materially affect the reliability of the DBOF consolidated financial statements. No recommendations were made in this report; therefore, management comments were not required, and none were received. Recommendations for the deficiencies cited in this report were addressed in the individual audit reports of the IG, DoD, and the Military Department audit organizations.

IG, DoD, Report No. 96-178, “Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1995,” June 26, 1996. This report states that the IG, DoD, was unable to render an opinion on the DBOF consolidated financial statements for FY 1995. Significant deficiencies in the accounting systems and lack of a sound internal control structure prevented the preparation of accurate financial statements. The IG, DoD, was unable to determine whether the account balances were fairly presented. Problems were found with crosswalking general ledger accounts to the financial statements, accounting for prior period adjustments, and computing depreciation charges. No recommendations were made in this report; therefore, management comments were not required, and none were received. Recommendations for the deficiencies cited in this report were addressed in the individual audit reports of the IG, DoD, and the Military Department audit organizations.
## Appendix B. Summary of Prior Coverage

### Other Related Prior Audit Reports

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<tr>
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<td>FY 96 Army Defense Business Operations Fund Financial Statement Followup Issues</td>
<td>April 7, 1997</td>
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<td>AA 97-172</td>
<td>FY 96 Army Defense Business Operations Fund Recommended Adjustments</td>
<td>January 22, 1997</td>
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<td>NAVAUDSVC</td>
<td>FY 1996 Consolidating Financial Statements of the Department of the Navy DBOF</td>
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<td>Selected Expenses Accounts, Airlift Services Division, Transportation Service Activity Group, Fiscal Year 1996</td>
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<td>96068003</td>
<td>Estimated Repair Prices</td>
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Appendix C. Laws and Regulations Reviewed

Subtitle III, Financial Management, Title 31, United States Code, including the requirements for accounting and accounting systems and information in Sections 3511, 3512, 3513, and 3514 and the financial statement requirements in Section 3515


Appendix C. Laws and Regulations Reviewed


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


*DoD Directive 5010.38 has been revised as "Management Control Program," August 26, 1996. This audit was performed under the April 1987 version of the Directive.*
### Appendix D. Summary of Work Performed

<table>
<thead>
<tr>
<th>Component</th>
<th>Business Area</th>
<th>FY 1996 Reported Expenses (thousands)</th>
<th>Scope of Audit Work Performed</th>
<th>Organizations Performing Audit Work</th>
<th>Audit Report Number</th>
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</tbody>
</table>

*Excludes intrafund eliminations and non-Business Area adjustments. After eliminations and adjustments, total expenses were $76.4 billion.
Appendix E. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

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

Department of the Navy

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

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force
Appendix E. Report Distribution

Other Defense Organizations

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

Non-Defense Federal Organizations

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

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

   Senate Committee on Appropriations
   Senate Subcommittee on Defense, Committee on Appropriations
   Senate Committee on Armed Services
   Senate Committee on Governmental Affairs
   House Committee on Appropriations
   House Subcommittee on National Security, Committee on Appropriations
   House Committee on Government Reform and Oversight
   House Subcommittee on Government Management, Information, and Technology,
       Committee on Government Reform and Oversight
   House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
   House Committee on National Security
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