

**A**udit



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INTERNAL CONTROLS AND COMPLIANCE WITH LAWS  
AND REGULATIONS FOR THE DOD AGENCY-WIDE  
FINANCIAL STATEMENTS FOR FY 1999

Report No. D-2000-091

February 25, 2000

Office of the Inspector General  
Department of Defense

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### **Acronyms**

CFO	Chief Financial Officer
DFAS	Defense Finance and Accounting Service
FBWT	Fund Balance with Treasury
FFMIA	Federal Financial Management Improvement Act of 1996
FMFIA	Federal Managers' Financial Integrity Act of 1982
FMIP	Financial Management Improvement Plan
GPRA	Government Performance and Results Act of 1993
IG	Inspector General
ODO-GF	Other Defense Organizations-General Funds
OMB	Office of Management and Budget
PP&E	Property, Plant, and Equipment
SAS	Statement on Auditing Standards
SFFAC	Statements of Federal Financial Accounting Concepts
SFFAS	Statements of Federal Financial Accounting Standards
USD(C)	Under Secretary of Defense (Comptroller)
USGSL	U.S. Government Standard General Ledger
WCF	Working Capital Fund



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
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February 25, 2000

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 the DoD Agency-Wide Financial Statements for FY 1999  
(Report No. D-2000-091)

We are providing this report for your information and use. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare annual financial statements. We conducted this audit in accordance with Government auditing standards and the requirements of the Office of Management and Budget Bulletin, "Audit Requirements for Federal Financial Statements." This Bulletin requires the Inspector General, DoD, to express an opinion on the DoD financial statements and to report on the adequacy of internal controls and compliance with laws and regulations.

We were unable to express an opinion on the DoD Agency-Wide financial statements for FY 1999 because DoD did not provide the financial statements in time for us to perform all the necessary audit work and because internal control weaknesses, compilation problems, and deficiencies in financial management systems continued to exist. This report discusses material weaknesses and reportable conditions, which were also reported in the management representation letter for the DoD Agency-Wide financial statements for FY 1999, the DoD Annual Statement of Assurance for FY 1999, and the DoD Financial Management Improvement Plan. Our disclaimer of opinion on the DoD Agency-Wide financial statements for FY 1999 is at Exhibit 3. The DoD Agency-Wide financial statements for FY 1999 are at <http://www.dtic.mil/comptroller/>.

We appreciate the courtesies extended to the audit staff. If you have any questions, please contact Mr. Richard B. Bird at (703) 604-9159 (DSN 664-9159), e-mail [rbird@dodig.osd.mil](mailto:rbird@dodig.osd.mil), or Ms. Cindi Miller at (317) 510-3855 (DSN 699-3855), e-mail [cmiller@dodig.osd.mil](mailto:cmiller@dodig.osd.mil). See Appendix D for the report distribution. The audit team members are listed inside the back cover.

*David K. Steensma*

David K. Steensma  
Deputy Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

**Audit Report No. D-2000-091**

(Project No. OFI-2115.01)

**February 25, 2000**

### **Internal Controls and Compliance With Laws and Regulations for the DoD Agency-Wide Financial Statements for FY 1999**

#### **Executive Summary**

**Introduction.** The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare annual audited financial statements. This is the first in a series of reports related to the DoD Agency-Wide financial statements for FY 1999.

The DoD Agency-Wide financial statements for FY 1999 are compiled from the financial statements of the DoD reporting entities: the Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; the Military Retirement Fund; the U.S. Army Corps of Engineers, Civil Works Program; and financial data for the Other Defense Organizations-General Funds and Working Capital Funds. In FY 1999, the DoD Components reported total assets of \$599 billion, total liabilities of \$999 billion, total net costs of operations of \$378 billion, and total budgetary resources of \$628 billion.

**Audit Objectives.** Our overall objective was to determine whether the DoD Agency-Wide financial statements for FY 1999 were prepared in accordance with Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended January 7, 2000. We also evaluated internal controls and compliance with laws and regulations.

**Disclaimer of Opinion.** DoD did not provide the DoD Agency-Wide financial statements for FY 1999 in time for us to perform all of the necessary audit work. Therefore, we did not verify the reported amounts. However, we identified deficiencies in internal controls and accounting systems related to \$119.3 billion of general property, plant, and equipment; inventory; \$80 billion of environmental liabilities; \$196 billion of military retirement health benefits liability; and material lines within the Statement of Budgetary Resources. Those deficiencies would have precluded an audit opinion. We also identified \$6.9 trillion in accounting entries to financial data used to prepare financial statements for the Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; Other Defense Organizations-General Funds; and Other Defense Organizations-Working Capital Funds. For the accounting entries, \$2.3 trillion was not supported by adequate audit trails or sufficient evidence to determine their validity, \$2 trillion was not reviewed because of time constraints, and \$2.6 trillion were supported.

The financial data reported on the FY 1999 financial statements for the Army, Navy, and Air Force General Funds and the Army, Navy, and Air Force Working Capital Funds were unauditible and represented a significant portion of the financial data reported on the DoD Agency-Wide financial statements for FY 1999. Because the financial

statements were not provided in a timely manner and because internal control weaknesses, compilation problems, and deficiencies in financial management systems continued to exist, we were unable to perform adequate audit tests of the various line item amounts reported on the financial statements. Therefore, we do not express an opinion on the DoD Agency-Wide financial statements for FY 1999. DoD has initiated numerous actions to improve financial accounting, but the actions are not complete. The unqualified opinion on the Military Retirement Fund is an example of positive accomplishments by DoD.

**Review of Internal Controls.** We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. However, these tests did not provide sufficient evidence to support an opinion on internal controls; therefore, we did not express an opinion on DoD internal controls. DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that adjustments to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-Wide financial statements for FY 1999, the DoD Annual Statement of Assurance for FY 1999, and the DoD Financial Management Improvement Plan.

**Review of Compliance With Laws and Regulations.** Our objective was to assess compliance with laws and regulations related to the DoD Agency-Wide financial statements for FY 1999 and not to express an opinion. Therefore, we did not express an opinion on compliance with laws and regulations. DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. We identified noncompliance issues related to the Federal Financial Management Improvement Act of 1996; the Chief Financial Officers Act of 1990; section 3512, title 31, United States Code (formerly the Federal Managers' Financial Integrity Act of 1982); and the Government Performance and Results Act of 1993.

**Management Comments.** The Deputy Chief Financial Officer commented that the Department did not have sufficient time to review and determine the validity of individual assertions in the report. The DoD has a two-track approach to comply with new Federal accounting standards. The DoD does not expect to have systems necessary to meet these new requirements before the year 2003. The DoD has undertaken an interim track that includes the use of contractors to address many of the existing deficiencies. As a result, DoD expects to make incremental progress in addressing a number of financial management challenges that impact the ability to produce audited financial statements. Appendix C contains the full text of the comments.

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# Introduction

## Background

**Reporting Requirements.** Public Law 101-576, the Chief Financial Officers Act of 1990, November 15, 1990, as amended by Public Law 103-356, the Federal Financial Management Act of 1994, October 13, 1994, requires DoD to prepare annual audited financial statements. In addition, the Federal Financial Management Act of 1994 requires the Secretary of the Treasury, in coordination with the Director, Office of Management and Budget (OMB), to prepare Government-wide financial statements beginning in FY 1997. The OMB Bulletin, “Audit Requirements for Federal Financial Statements,” establishes the minimum requirements for audits of Federal financial statements. This is the first in a series of reports related to the DoD Agency-Wide financial statements for FY 1999.

**Accounting Functions and Responsibilities.** The Under Secretary of Defense (Comptroller) (USD[C]), as the Chief Financial Officer (CFO), is responsible for overseeing all financial management activities related to the programs and operations of DoD. The Defense Finance and Accounting Service (DFAS) performs accounting functions and prepares financial statements for DoD. DFAS operates under the control and direction of the USD(C). DFAS is responsible for entering information from DoD entities into finance and accounting systems, operating and maintaining the finance and accounting systems, and ensuring the continued integrity of the information entered. The DoD reporting entities are responsible for providing accurate financial information to DFAS through the feeder systems.

**Internal Control Responsibilities.** As the CFO, the USD(C) oversees all financial management activities for DoD programs and operations, including the accounting functions of DFAS. The Military Departments, Defense agencies, and DoD field activities are responsible for managing their operations. Establishing and maintaining internal controls appropriate to the entity is an important management responsibility. 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;
- 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 Inspector General (IG), DoD, have identified as being significant and for which compliance can be objectively measured and evaluated; and

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- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

**Compliance Responsibilities.** The CFO is also responsible for compliance with laws and regulations applicable to the DoD Agency-Wide financial statements. The Military Departments, Defense agencies, and DoD field activities are responsible for compliance with laws and regulations applicable to their organizations. Compliance with laws and regulations is an important management responsibility and is essential for proper financial reporting.

**Accounting Policy.** The DoD Agency-Wide financial statements for FY 1999 were to be prepared in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended January 7, 2000. Footnote 1 to the financial statements discusses the significant accounting policies followed in preparing the financial statements.

**Scope of DoD Operations.** In employment and discretionary spending authority, DoD is the largest Government agency. In FY 1999, DoD employed about 2.1 million active-duty Service members and civilian personnel and about 1.35 million reservists and National Guard members. In FY 1999, the DoD Components reported total assets of \$599 billion, total liabilities of \$999 billion, total net costs of operations of \$378 billion, and total budgetary resources of \$628 billion.

**Adequacy of DoD Guidance.** DoD and DFAS reporting guidance were not adequate. The DoD guidance did not adequately address reporting the elimination of intergovernmental transactions, and instructed the DFAS Centers to make forced entries so that accounting records would show balanced accounts. To report amounts for accrued accounts payable, DFAS also instructed the DFAS Centers to use data that could not be verified by auditors.

**Disclaimer of Opinion.** DoD did not provide the DoD Agency-Wide financial statements for FY 1999 in time for us to perform all of the necessary audit work. However, we identified deficiencies in internal controls and accounting systems related to general property, plant, and equipment (PP&E); inventory; environmental liabilities; military retirement health benefits liability; and material lines within the Statement of Budgetary Resources. Those deficiencies would have precluded an audit opinion. We also identified \$2.3 trillion in accounting entries to financial data used to prepare financial statements for the Army, Navy, and Air Force General Funds and the Army, Navy, and Air Force Working Capital Funds. Those accounting entries were not supported by adequate audit trails or sufficient evidence to determine their validity.

The financial data reported on the FY 1999 financial statements for the Army, Navy, and Air Force General Funds and the Army, Navy, and Air Force Working Capital Funds were unauditible and represented a significant portion of the financial data to be reported on the DoD Agency-Wide financial statements for FY 1999.

Because the financial statements were not provided in a timely manner and internal control weaknesses, compilation problems, and deficiencies in financial management systems continued to exist, we were not able to perform adequate



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audit tests of the various line item amounts reported on the financial statements. As a result, we do not express an opinion on the DoD Agency-Wide financial statements for FY 1999. Our disclaimer of opinion is at Exhibit 3.

## **Objectives**

Our overall audit objective was to determine whether the DoD Agency-Wide financial statements for FY 1999 were presented fairly in accordance with Generally Accepted Accounting Principles and OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended January 7, 2000. As part of this objective, we determined whether internal controls were adequate to ensure that the DoD Agency-Wide financial statements for FY 1999 were free of material error, and we assessed DoD compliance with laws and regulations for transactions and events that had a direct and material effect on the financial statements.

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# **Review of Internal Controls**

## **Overview of Material Weaknesses**

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 the internal controls 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.

We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. However, these tests did not provide sufficient evidence to support an opinion on internal controls; therefore, we do not express an opinion on the DoD internal controls. DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that accounting entries to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-Wide financial statements for FY 1999 (Exhibit 1), the DoD Annual Statement of Assurance for FY 1999, and the DoD Financial Management Improvement Plan (FMIP).

Statement on Auditing Standards (SAS) No. 82, "Consideration of Fraud in a Financial Statement Audit," February 1997, requires us to specifically assess the risk of material misstatement of the financial statements because of fraud and to consider that assessment in designing audit procedures to be performed. We included an assessment of fraud risk in our review of internal controls.

## **Internal Control Components**

SAS No. 78, "Consideration of Internal Controls in a Financial Statement Audit: An Amendment to SAS No. 55," December 1995, defines internal controls as a process performed by an entity's board of directors, management, or other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. SAS No. 78 states that internal controls consist of five interrelated components:

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- the control environment,
  - risk assessment,
  - control activities,
  - information and communication, and
  - monitoring.

## Control Environment

The control environment includes factors that set the tone of an organization, influencing the control consciousness of its employees. The control environment includes several organizational factors, such as management's philosophy and commitment to competence. The ability of DoD to prepare auditable financial statements would be improved if:

- DoD continued to revise system improvement plans;
- DoD provided adequate guidance to the DoD Components for preparing financial statements; and
- the CFO provided auditable and timely financial statements.

We identified similar problems with DoD financial reporting guidance and financial statements for FYs 1998 and 1997. A discussion of these issues was included in IG, DoD, Report No. 99-097, "Internal Controls and Compliance With Laws and Regulations for the DoD Agency-Wide Financial Statements for FY 1998," March 1, 1999, and IG, DoD, Report No. 98-161, "Internal Controls and Compliance With Laws and Regulations for the DoD Consolidated Financial Statements for FY 1997," June 22, 1998.

**Plans to Improve Financial Management.** Auditors identified and DoD financial managers acknowledged that the overarching deficiency preventing favorable audit opinions is the lack of adequate financial management and feeder systems for compiling accurate and reliable financial data. In response, DoD implemented two major efforts to improve financial management, the FMIP and the DoD Implementation Strategies. Although DoD has made some progress in implementing these two major efforts, several factors have shown that DoD must continue to revise and improve these plans.

**DoD Financial Management Improvement Plan.** DoD evaluated 44 of the 67 systems identified as long-term critical finance, accounting, and feeder systems. The Office of the USD(C) tasked the DoD Components with completing the remaining system evaluations by March 31, 2000. System evaluations are the first step in preparing plans to correct deficiencies in financial management systems. DoD must continue to identify all critical finance, accounting, and feeder systems that affect the amounts reported on the financial statements and must clearly identify system deficiencies. DoD cannot provide reasonable

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estimates of the resources or milestones necessary to achieve favorable audit opinions without a complete inventory of systems and specific plans to correct system deficiencies.

The FMIP acknowledged that the DoD managerial cost accounting systems had several problems to overcome. These problems prevented effective cost management. The FMIP did not discuss the details of the actions needed to correct the cost accounting deficiencies. For example, DoD did not have adequate managerial cost accounting systems in place to collect, process, and report \$377.9 billion in total operating costs by program area consistent with DoD performance plans. DoD was unable to adequately address managerial cost accounting system deficiencies in the FMIP because DoD had not identified the cost accounting information needed in order to establish program categories that were consistent with Government Performance and Results Act performance plans. DoD must determine and define its cost accounting requirements before discussing details of actions needed to correct its deficient cost accounting systems.

**DoD Implementation Strategies.** As an interim solution until compliant financial management and feeder systems are in place, DoD was improving other aspects of its financial management through various initiatives. One such initiative was the development of DoD Implementation Strategies for financial management areas needing improvement. In May 1998, the CFO began developing Implementation Strategies to achieve a favorable opinion on the DoD Agency-Wide financial statements until compliant financial management and feeder systems are in place. As of January 2000, DoD had developed and approved a total of 12 Implementation Strategies. The Office of Management and Budget, the General Accounting Office, and the Inspector General, DoD, reviewed each of the strategies and concluded that, generally, the strategies were a reasonable short-term approach to removing impediments to favorable audit opinions. However, additional information was needed to make some of the strategies more complete. In addition, review of the proposed milestones for the strategies showed that, in many cases, milestones had not been met and will need to be revised. The Implementation Strategies are a step towards achieving a favorable audit opinion. However, the Inspector General, DoD, USD(C), Office of Management and Budget, and the General Accounting Office believe that the DoD long-term plan needs to address additional areas related to financial management systems and processes.

**DoD Guidance.** The DoD guidance did not require adequate support for intra-Governmental eliminations. The DoD guidance provided instructions to adjust the buyer-side data to agree with the seller-side data, without conducting the proper research to reconcile the difference. For example, DFAS processed an adjustment of \$2.7 billion to the Army Working Capital Fund, adjusting to the buyer-side data without any research or reconciliation. As a result, DoD reported over \$89.7 billion in intra-agency expenses and \$4.4 billion in intra-agency payables that could not be verified. Because intra-agency revenues and receivables were not properly reconciled with expenses and payables, the reliability of the earned revenues reported in the Statement of Net Cost and Accounts Receivable reported on the Balance Sheet were questionable. DoD also misstated the program costs on the Statement of Net Cost. DoD eliminated \$89.7 billion from total earned revenue and total program costs without

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allocating the amounts to each program cost, as shown in OMB Bulletin No. 97-01. Instead, DoD eliminated \$89.7 billion from the bottom line total only. Therefore, costs related to DoD programs were misstated.

**Guidance Issued by DFAS.** DFAS issued guidance to its personnel to record accounts payable on the financial statements. However, the DFAS guidance instructed the DFAS Centers to use data from a finance system that contained control weaknesses. This resulted in amounts reported on the financial statements that could not be verified by the auditors. DFAS issued “Use of MOCAS Supplementary Information for Accounts Payable in Financial Statements” on September 29, 1999. This guidance was to be used to prepare the FY 1999 financial statements. Many DoD accounting systems were not integrated with logistics and payments systems, and as a result, did not receive the information necessary for maintaining or developing an accounts payable balance. According to the DFAS guidance, the greatest deficiency in accounts payable information is in outside payments made through the Mechanization of Contract Administration System (MOCAS) for contract payments. The DFAS guidance stated that reports from MOCAS would be generated and this information was to be used to supplement the accounts payable amounts in accounting systems when other transaction or system sources were not used. In our audit report No. 98-007, “General and Application Controls over the Mechanization of Contract Administration Services System,” October 9, 1997, we concluded that control weaknesses existed that made payment data vulnerable to inappropriate manipulation. Therefore, data extracted from MOCAS had a greater risk of being unreliable. DoD made \$1.7 billion in accounting entries to the Army General Fund, Navy General Fund, and Air Force General Fund financial statements for accounts payable data extracted from MOCAS. Although DFAS prepared guidance to more completely report accounts payable balances, the amounts reported for accounts payable could not be verified because of system control weaknesses.

**Auditability of DoD Agency-Wide Financial Statements.** DoD did not provide us with the DoD Agency-Wide financial statements for FY 1999 in time for us to perform all of the necessary audit work. We examined internal controls over the process for compiling DoD financial statements, and identified internal control weaknesses and financial management deficiencies that impaired the ability of DoD to prepare auditable financial statements. Problems with the guidance and the availability of the financial statements were previously reported in our Disclaimer of Opinion on the DoD Consolidated Financial Statements for FY 1998 and FY 1997 (included in the financial statements published by DoD); IG, DoD, Report No. 99-097, “Internal Controls and Compliance With Laws and Regulations for the DoD Agency-Wide Financial Statements for FY 1998,” March 1, 1999; and IG, DoD, Report No. 98-161, “Internal Controls and Compliance With Laws and Regulations for the DoD Consolidated Financial Statements for FY 1997,” June 22, 1998. Until DoD improves its financial management and provides the auditors with timely financial statements, DoD will not be able to achieve favorable audit opinions.

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## Risk Assessment

For financial reporting purposes, an entity's risk assessment is its identification, analysis, and management of risks relevant to the preparation of financial statements following generally accepted accounting principles. The DFAS Indianapolis Center, Indianapolis, Indiana, considered the compilation process for the annual financial statements for the Army General Fund, Army Working Capital Fund, and the Other Defense Organizations-General Funds as a high-risk area and has worked to improve this process. At the end of FY 1999, DFAS added contractor support to assist in compiling the financial statements. However, the DFAS Indianapolis Center also added additional steps to the compilation process. These new steps increased the risk of errors and material misstatements because the revised compilation process had not been fully tested before use. The DFAS Indianapolis Center expanded the compilation process from four to five steps for the Army General Fund, from three to five steps for the Army Working Capital Fund, and from three to six steps for the Other Defense Organizations-General Funds. This required additional crosswalks, queries, and software applications. We support the DFAS decision to allocate additional resources to improve the compilation process. However, the procedures and crosswalks were not fully mapped and tested before the compilation process began. This created problems, and we were unable to test the controls for the new process before its execution.

## Control Activities and Information and Communication

Control activities are the various policies and procedures that help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Information and communication activities include the accounting system, consisting of the methods and records established to record, process, summarize, and report entity transactions and to maintain accountability of the related assets and liabilities. To be effective, the information and communication system must identify and record all valid transactions; describe transactions on a timely basis; properly measure the value of transactions; record transactions in the proper time period; properly present and disclose transactions; and communicate responsibilities to employees. Control activities relate to procedural internal control activities, and information and communication activities are system-related internal control activities. During our review of DoD internal controls related to control activities and information and communication activities, we identified both procedural and system-related problems.

**Procedural Problems.** Procedural problems were tied predominantly to accounting and reporting procedures and the application of accounting and reporting standards. The FMIP acknowledged procedural problems that existed in DoD.

**Accounting Entries.** DoD processed at least \$6.9 trillion in accounting entries to the DoD Components' financial data that affected the amounts reported on the DoD Agency-Wide financial statements for FY 1999. These entries were processed to force financial data to agree with various data sources, to correct errors, and to add new data. Of the \$6.9 trillion, proper reconciliations were performed and adequate audit trails were available to support \$2.6 trillion of these entries. However, accounting entries of \$2.3 trillion were not supported by

adequate audit trails or sufficient evidence to determine their validity. Because of time constraints, we did not review the remaining \$2 trillion; therefore, we did not determine whether they were adequately supported. The magnitude of accounting entries required to compile the DoD financial statements highlights the significant problems DoD has producing accurate and reliable financial statements with existing systems and processes. The following table identifies the results of our review of accounting entries made to the DoD Components' financial data.

<b>Accounting Entries Affecting the DoD Agency-Wide Financial Statements for FY 1999 (Billions)</b>				
<b>Reporting Entity</b>	<b>Supported Entries</b>	<b>Unsupported Entries</b>	<b>Unreviewed Entries</b>	<b>Total Entries</b>
Army GF	\$165.6 (98)	\$239.9 (187)	\$14.9 (6)	\$420.4 (291)
Army WCF	\$54.0 (90)	\$127.8 (105)	\$0.0 (0)	\$181.8 (195)
Navy GF	\$158.9 (276)	\$1,463.2 (9,348)	\$1,781.5 (4,789)	\$3,403.6 (14,413)
Navy WCF	\$221.8 (109)	\$129.6 (160)	\$245.6 (753)	\$597.0 (1,022)
Air Force GF	\$1,157.0 (558)	\$66.6 (98)	\$0.0 (0)	\$1,223.6 (656)
Air Force WCF	\$218.9 (481)	\$93.0 (334)	0.0 (0)	\$311.9 (815)
ODO-GF	\$513.3 (53)	\$122.3 (13)	0.4 (19)	\$636.0 (85)
ODO-WCF	\$65.6 (61)	\$48.1 (118)	*	\$113.7 (179)
<b>Total</b>	<b>\$2,555.1 (1,726)</b>	<b>\$2,290.5 (10,363)</b>	<b>\$2,042.3 (5,567)</b>	<b>\$6,888.0 (17,656)</b>

\* The scope of accounting entries reviewed for the ODO-WCF was limited to DLA and ODO-WCF adjustments processed by the DFAS Denver Center. Therefore, the total amount of accounting entries to the ODO-WCF financial statements is unknown.

In FY 1999, we reviewed portions of the accounting entries for DoD reporting entities and identified approximately \$1.7 trillion in unsupported accounting entries made to the FY 1998 DoD Components' financial statements that affected the DoD Agency-Wide financial statements for FY 1998. Despite the increase in the amount of unsupported accounting entries from the previous year for some reporting entities, some progress has been made by other reporting entities. The DFAS Indianapolis Center decreased the amount of unsupported

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accounting entries processed into the financial data used to compile the Army General Fund financial statements from \$673 billion in FY 1998 to \$240 billion in FY 1999.

Although we determined that proper reconciliations were performed and adequate audit trails existed to support \$2.6 trillion of the accounting entries, it is important to note that many of these were corrections of errors or resulted from data provided to the DFAS Centers from outside sources over which they had little or no direct influence and that could not be verified by auditors.

**Error Corrections.** Error corrections of \$549 billion to the DoD Components' financial data affected the amounts reported on the DoD Agency-Wide financial statements for FY 1999. Although support existed for these adjustments, error corrections must be minimized to ensure the integrity of the financial data.

**Data from Sources Outside of DFAS.** Data for some reported amounts on the balance sheet were obtained from sources outside of DFAS. Although DFAS had proper support for these accounting entries, the amounts reported could not be verified by auditors. As previously discussed, the \$79.8 billion reported for Environmental Liabilities could not be verified by the auditors because of insufficient controls and inadequate audit trails used by DoD to develop the estimate. In addition, the Assistant Secretary of Defense (Health Affairs) acknowledged that the \$196 billion reported for the military retirement health benefits liability was unreliable.

As a result of these accounting entries, the DoD Agency-Wide financial statements for FY 1999 were subject to a high risk of material misstatement. The lack of research, reconciliation, and audit trails impaired the auditors' ability to validate the accounting entries. Additional detail on these accounting entries will be provided in a separate report.

**Fund Balance With Treasury (FBWT).** We were unable to assess the reliability of the \$175.6 billion reported for FBWT on the DoD Agency-Wide financial statements for FY 1999. The DoD disbursing stations and DFAS centers did not resolve discrepancies between disbursing data and various other data sources, and the discrepancies continued to affect the accuracy of the FBWT account. As of September 30, 1999, the U.S. Treasury reported about \$7.1 billion (absolute value) of unreconciled differences to DoD, including differences of \$1.5 billion in deposits, \$1.2 billion in interagency transfers, and \$4.4 billion in checks issued.

**Army General Fund.** Unreconciled differences in checks issued and online payments and collections for balances over 60 days old at fiscal year's end totaled about \$339 million and were material with regard to the FBWT balance of \$32.3 billion for the Army General Fund.

**Navy Working Capital Fund.** DFAS did not perform cash reconciliations between disbursing system records and activity general ledgers and did not retain supporting documentation.

**Other Defense Organizations-General Funds.** Instead of using general ledger accounts, DFAS used data from SF 133, Reports of Budget Execution, to create trial balances for seven reporting entities included in Other Defense



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Organizations-General Funds. Reports of Budget Execution do not contain financial data for the entire scope of an entity's operations, and are therefore incomplete. The combined balances from the seven reporting entities totaled \$4.4 billion for FBWT.

**Problem Disbursements.** DoD had difficulties with its complex and inefficient payment processes and systems. DFAS has made progress in reducing in-transit disbursements and has reported progress in reducing the dollar values of problem disbursements; however, as of FY 1999, DoD reported \$12.1 billion (absolute value) of problem disbursements and in-transit disbursements. The lack of integrated finance and accounting systems caused disbursing stations to make disbursements that were accounted for by stations that were not collocated with the disbursing stations. Problem disbursements occurred when the accountable station could not match the disbursement to the correct detailed obligation or when matching the disbursement to the corresponding obligation caused the total disbursement to exceed the amount of the recorded obligation. In-transit disbursements occurred when DoD reported a disbursement to the U.S. Treasury, but the disbursement was not received or was not processed by an accountable station. DFAS and the DoD Components have spent considerable time and effort reviewing the causes of problem disbursements and developing actions to reduce their creation. Problem disbursements and in-transit disbursements can increase the risks of:

- fraudulent or erroneous payments being made without detection,
- cumulative amounts of disbursements exceeding appropriated amounts and other legal spending limits, and
- inaccurate and unreliable financial reporting.

Further progress in reducing problem disbursements and in-transit disbursements is essential to meeting DFAS goals and improving the accuracy and reliability of financial reporting.

**Military Retirement Health Benefits Liability.** DoD continued to have problems with accurately reporting its military retirement health benefits liability. Outpatient visit data in the Composite Health Care System were unreliable for use in developing the FY 1998 estimate of the military retirement health benefits liability. Outpatient medical care services represented \$100 billion of the reported FY 1998 unfunded liability of \$223 billion. The Assistant Secretary of Defense (Health Affairs) agreed that the data were unreliable and acted to improve the quality of data in time to affect the FY 2001 estimate. Therefore, the FY 1999 estimate of \$196 billion was based on unreliable data. In addition to outpatient visit data, the DoD information used to determine the cost of medical care is being reviewed by a DoD working group, which is developing more complete cost information for use in making the estimate.

**Environmental Liabilities.** For FY 1999, \$79.7 billion reported for DoD environmental liabilities could not be verified because of insufficient controls and inadequate audit trails. In addition, several major DoD programs did not develop total life-cycle cost estimates for demilitarization, disposal, and associated cleanup. The IG, DoD, issued separate reports on incomplete environmental cost

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estimates for the following major DoD programs:

- The Grizzly, an Army vehicle designed with a full-vehicle-width mine-clearing blade.
- The C/KC-135 Stratotanker Aircraft.
- The T-45 Undergraduate Jet Pilot Training System.
- The UH-60 Black Hawk Helicopter, a utility helicopter.
- The F-15 Eagle.
- The F-15 Strike Eagle.
- The Nimitz-Class Nuclear Aircraft Carrier.

As a result, the Environmental Liabilities reported on the DoD Agency-Wide financial statements for FY 1999 were unreliable and likely to be materially understated.

**System-Related Problems.** System-related problems were tied predominantly to weaknesses in DoD financial management systems. The FMIP generally discussed many system-related problems in DoD.

**General Property, Plant, and Equipment.** We were unable to verify the \$119.3 billion reported for DoD general PP&E because of a lack of supporting documentation. We identified significant problems related to the accuracy of data in DoD real property databases that affected the accuracy of amounts reported for real property.

- The Military Services did not accurately record additions, deletions, and capital improvements made to real property in the databases.
- The values in the real property databases may not have been accurately reported. The Military Departments often did not have the documentation required to value the \$5.6 billion in changes made to their databases for FY 1999.
- Completed real property projects were not always removed from the construction-in-progress account and were not always properly valued.
- The Military Departments did not perform the required 5-year periodic inventories as required by the DoD form and content guidance.
- Not all real property that met the capitalization threshold was actually capitalized.

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In addition, the Military Department audit agencies reported the following issues.

**Army General Fund.** The auditors reviewed about \$408 million of FY 1999 real property transactions at 23 locations. Transactions valued at about \$113 million, or about 27 percent, were completed in prior periods and should have been reported in prior periods. In addition, about \$43 million of real property values were omitted from the FY 1999 financial statements because supporting documentation was not prepared or was not provided to real property offices.

**Army Working Capital Fund.** Army automated systems did not compute depreciation for real property and did not capitalize the cost of buildings and improvements to assets.

**Navy Working Capital Fund.** Net asset values for general PP&E for supply management were not transaction-based because no wall-to-wall inventory was performed to provide values for each item. Controls over net acquisition, disposals, and capital improvements were not adequate to detect or prevent errors because of management inattention, insufficient staffing, and lack of training.

**Air Force General Fund.** Because of a backlog in recording real property transactions, the Air Force materially understated the value of real property. Further, the Air Force reported \$1.8 billion of construction-in-progress that could not be verified because the Air Force did not ensure that the Army Corps of Engineers and the Naval Engineering Command provided supporting documentation in sufficient detail to allow auditors to confirm the reported amounts.

**Air Force Working Capital Fund.** Air Force depot maintenance systems did not follow the percentage-of-completion method of accounting and continue to account for work-in-process at estimated amounts instead of actual cost.

**Defense Logistics Agency.** Auditors could not verify that the reported \$2.6 billion acquisition value of PP&E and the \$1.62 billion of accumulated depreciation reported for the Defense Logistics Agency were complete and accurate. The Defense Logistics Agency and DFAS had not fully developed procedures to reconcile the PP&E recorded in the property system with information in the accounting system, and Defense Logistics Agency personnel misinterpreted DoD financial reporting policy.

**Required Supplementary Stewardship Information.** Stewardship information includes national defense PP&E, heritage assets, stewardship land, non-Federal physical property, and research and development. The SFFAS gave conflicting guidance. The original SFFAS No. 8, the exposure draft for SFFAS Nos. 6 and 8, did not agree with SFFAS No. 11, which officially amended SFFAS Nos. 6 and 8. In addition, the Federal Accounting Standards Advisory Board was holding deliberations on whether or not to present historical cost for stewardship assets. This information was not required to be audited, and we did not audit the information.

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**Inventory and Related Property.** DoD financial management systems were unable to accurately report amounts reported for inventory and related property on the DoD Agency-Wide financial statements for FY 1999. The inventory and related property line item consists of inventory, operating materials and supplies, and stockpile materials. Internal controls over inventory were inadequate. In addition, DoD Components were unable to value operating materials and supplies at historic cost, did not use generally accepted accounting principles to expense operating materials and supplies, and had not completed development of a standard definition of items that constitute operating materials and supplies.

**Army General Fund.** Internal controls were not fully effective over the reporting of munitions as inventory and the related impact on stewardship reporting. The Army did not have controls to ensure that \$2.4 billion of missile-related equipment reported on the stewardship report was subtracted from the value of munitions reported on the balance sheet.

**Army Working Capital Fund.** At Army retail storage locations, the financial records were not reconciled with the logistical records, and storage locations did not process receipt and turn-in transactions in a timely manner. In addition, the Army did not have reliable data on the value of items in transit.

**Navy General Fund.** The amount reported for inventory on the Navy General Fund financial statements could not be verified because reporting systems were not designed to ensure that all inventory items were included in the values reported. In addition, shipboard operating materials and supplies were excluded because the systems used to report the values could not fully support the required accounting methodology.

**Navy Working Capital Fund.** Inventory was not accurately reported because the inventory valuation model contained material misstatements caused by weaknesses in the standard operating procedures and by the treatment of accounts that were period gains and losses as allowances. In addition, inventory in-transit from customers and inventory for agency operations (supplies and materiel) could not be verified because Navy Working Capital Fund logistics activities and the DFAS Cleveland Center, Cleveland, Ohio, did not reconcile the general ledger account balances to subsidiary records.

**Air Force General Fund.** The Air Force used standard price to value operating materials and supplies, which did not comply with Federal accounting standards, and did not recognize holding gains and losses related to revaluation of operating materials and supplies. In addition, the Air Force did not revalue operating materials and supplies at their net realizable value when they were identified as excess, obsolete, or unserviceable in accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 3.

**Air Force Working Capital Fund.** System limitations prevented the Air Force from providing sufficient audit trails to confirm and value the in-transit inventory reported as part of inventory held for sale.

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**Defense Logistics Agency.** The Defense Logistics Agency logistics and financial systems did not capture the data needed to value year-end inventories at historical cost, and insufficient information was available from the Defense Logistics Agency during the audit for us to assess the accuracy of the inventory pricing data in the logistics systems.

**Statement of Budgetary Resources.** We were not able to obtain sufficient evidence to support amounts reported on the Statement of Budgetary Resources. In some cases, DoD did not use a transaction-driven general ledger to prepare the Statement of Budgetary Resources, and audit trails were inadequate.

**Army General Fund.** Personnel at the DFAS Indianapolis Center had to rely on fund control data for part of the data reported in the Statement of Budgetary Resources instead of using accounting data from the general ledger, as required. Personnel had to develop crosswalks and complicated formulas to convert the data for the Statement of Budgetary Resources. The lack of financial management systems and the use of alternative procedures for preparing the financial statements meant that adequate audit trails were not available.

**Army Working Capital Fund.** The DFAS Indianapolis Center did not use the general ledger to prepare the Statement of Budgetary Resources. Instead, the DFAS Indianapolis Center used information from budgetary reports. Auditors were unable to verify the reported amounts because detailed transactions were not available for review.

**Navy General Fund.** Controls for disbursement and collection functions were not adequate to ensure that documentation was available to support all transactions. This deficiency limited the auditors' ability to attest to the validity of the reported transactions and subsequently the balance of outlays on the Statement of Budgetary Resources.

**Air Force Working Capital Fund.** The DFAS Columbus Center, Columbus, Ohio, could not provide documentation to support \$149 million in disbursements, collections, and adjustments for 119 of 345 transactions tested that were reported on the Air Force Working Capital Fund financial statements.

**Other Defense Organizations-General Funds.** Controls used to compile departmental Reports of Budget Execution, which were later used to compile the Statement of Budgetary Resources, did not provide reasonable assurance that the information on those reports was accurate and reliable. The Reports of Budget Execution were not reliable because the DFAS Indianapolis Center did not adequately footnote \$3 billion of abnormal balances and made at least \$13.4 billion of unsupported adjustments to force the report to match U.S. Treasury records.

**Information Security.** Security and application controls over financial management systems are critical to ensuring the integrity of data reported on the DoD Agency-Wide financial statements for FY 1999. DoD has become increasingly dependent on automated information systems to carry out its operations and to process, maintain, and report information in the annual financial statements. To date, DoD has identified at least 168 automated systems that process, maintain, and report financial information. We issued four reports that identified security and application control weaknesses over systems that affected

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the amounts reported on the DoD Agency-Wide financial statements for FY 1999.

**Defense Civilian Pay System.** The Defense Civilian Pay System serves 773,000 employees and processes more than \$38 billion in payroll transactions annually. We concluded in IG, DoD, Report No. 99-128, "Computer Security for the Defense Civilian Pay System," April 7, 1999, that DFAS and the Defense Information Security Agency needed to improve computer security over the Defense Civilian Pay System and its mainframe computers. For example, user access to sensitive privileges and mandatory password requirements were not adequately controlled, inactive user identifications were not deleted when access was no longer required, and password controls were not adequately administered. Although no instances of fraud or abuse were detected, the integrity of the civilian pay data was at risk.

**Retiree and Casualty Pay Subsystem.** The Retiree and Casualty Pay Subsystem accounted for 1.8 million retirees and disbursed an average of \$22.8 billion from the DoD Military Retirement Fund in FY 1998. We concluded in IG, DoD, Report No. 99-083, "Application Controls Over the Retiree and Casualty Pay Subsystem at the Defense Finance and Accounting Service Cleveland Center," February 23, 1999, that DFAS did not fully implement or maintain controls over the accuracy of information in the Retiree and Casualty Pay Subsystem. Although we did not detect unauthorized or fraudulent activity, controls needed to be strengthened to ensure that data were accurate.

**Annuitant Pay Subsystem.** The Annuitant Pay Subsystem accounted for more than 257,000 annuitants and disbursed an average of \$1.7 billion from the DoD Military Retirement Fund in FY 1998. We concluded in IG, DoD, Report No. 99-110, "Application Controls Over the Annuitant Pay Subsystem at the Defense Finance and Accounting Service Denver Center," March 23, 1999, that DFAS had not fully implemented or maintained controls over the accuracy of information in the system. Although we did not detect unauthorized or fraudulent activity, controls needed to be strengthened to ensure the accuracy of annuity payments.

**General Accounting and Finance System.** The General Accounting and Finance System accommodates the Air Force's standard appropriation accounting records, including funding authority, commitments, obligations, and balances of available funds. The system processes approximately \$125 billion in transactions annually. We concluded in IG, DoD, Report No. 99-233, "General Controls of the General Accounting and Finance System," August 17, 1999, that the General Accounting and Finance System's general controls were limited and could not provide reasonable assurance that the program and data files were protected from unauthorized access and modification. As a result, auditors may not be able to rely on data from the General Accounting and Finance System without substantial verification.

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## **Monitoring**

Monitoring assesses the quality of internal control performance over time and involves assessing the design and operation of controls on a timely basis and taking the necessary corrective actions. Monitoring activities are accomplished through ongoing activities, separate evaluations, or a combination of the two.

DoD conducted significant monitoring activities during FY 1999. DoD continued to revise the FMIP and the Implementation Strategies to identify and address financial management problems and the remedies in place to correct financial management practices and systems. DoD made progress in implementing the FMIP and the Implementation Strategies. However, DoD must continue to revise and improve these efforts to ensure that progress continues toward improved financial management.

We identified areas where DoD could improve its monitoring activities related to the preparation of the DoD Agency-Wide financial statements for FY 1999. We determined that a primary cause of inconsistent, inaccurate, and incomplete reporting was the inability of DoD to perform adequate reviews and reconciliations while preparing the financial statements. As previously discussed, we identified \$2.3 trillion in unsupported accounting entries that affected amounts reported on the DoD Agency-Wide financial statements for FY 1999. Many of these entries were the result of inadequate reviews and reconciliations. Reviews and reconciliations are a key monitoring activity that help to identify problems in financial management and reporting. Implementation and consistent use of reviews and reconciliations will improve the ability of DoD to identify and solve problems and produce auditable financial statements.

## **Assessment of Fraud Risk**

SAS No. 82 requires us to specifically assess the risk of material misstatement of the DoD Agency-Wide financial statements for FY 1999 due to fraud, and to consider that assessment in designing audit procedures to be performed. SAS No. 82 describes two types of fraud that are relevant to the auditors' consideration of fraud in a financial statement audit: misstatements arising from fraudulent reporting and misstatements arising from misappropriation of assets. For each of the two types of fraud, SAS No. 82 identifies fraud risk factors that auditors should consider.

### **Risk Factors for Misappropriation of Assets**

Risk factors for misappropriation of assets included:

- large amounts of cash on hand or processed;
- inventory characteristics, such as small size, high volume, or high demand;
- lack of appropriate management oversight;

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- inadequate recordkeeping;
  - lack of appropriate segregation of duties or independence checks;
  - lack of an appropriate system for authorization and approval of transactions;
  - poor physical safeguards over assets; and
  - lack of timely and appropriate documentation for transactions.

All audits conducted by the IG, DoD, include steps to provide reasonable assurance of detecting fraud or other illegal acts. Any suspected instances of fraud or other illegal acts are coordinated with the Defense Criminal Investigative Service. Most of these referrals involve misappropriation of assets. In February 2000, the Defense Criminal Investigative Service had about 80 open cases that involved DoD financial operations.

We were unable to determine the effects of these fraud investigations on the DoD Agency-Wide financial statements for FY 1999. However, these investigations demonstrated that DoD was vulnerable to misappropriation of assets. This is particularly true for DoD contractors or DoD employees with malicious intent. Their knowledge of systemic weaknesses in DoD would make it easier for them to commit and disguise inappropriate actions.

## **Risk Factors for Fraudulent Financial Reporting**

Risk factors for fraudulent financial reporting included:

- motivation for management to engage in fraudulent financial reporting;
- failure of management to display and communicate an appropriate attitude regarding internal controls and the reporting process;
- excessive participation by nonfinancial management in selecting accounting principles or determining significant estimates;
- assets, liabilities, revenues, and expenses based on significant estimates that involved unusually subjective judgments or uncertainties; and
- significant, unusual, or highly complex transactions or adjustments, especially those close to year's end, that posed difficult questions.

Based on our financial audits, we determined that many of the fraudulent financial reporting risk factors were present within DoD. For example:

- DFAS processed substantial unsupported year-end adjustments to prepare and ensure consistency in DoD financial statements.



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- DoD reporting entities were unable to provide auditors with adequate audit trails linking financial statement data to supporting transaction-level data.
  - DoD reporting entities were unable to demonstrate adequate accounting control over DoD assets.
  - DoD financial management processes and systems and controls were not adequate.

These examples are discussed in greater detail in this report in the section on Control Environment and the section on Control Activities and Information and Communication.

The presence of these risk factors did not necessarily indicate fraudulent financial reporting. However, the presence of these risk factors in DoD, combined with the fraud investigations conducted by the Defense Criminal Investigative Service, indicated an increased level of risk of material misstatements and that the control environment in DoD was susceptible to fraudulent financial reporting. The existence of many of these fraud risk factors was due to the fact that financial reporting in DoD is an evolving process. DoD is adapting many existing nonfinancial procedures and systems to fulfill more stringent financial management and reporting requirements.

## **Conclusion**

Although considerable progress has been made, DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that accounting entries impacting financial data were fully supported and that assets, liabilities, costs, and budget resources were properly accounted for and reported. DoD financial reporting guidance was inadequate, and DoD did not provide the financial statements to the auditors in a timely manner. These problems are not new, but are recurring problems that DoD needs to address and correct.

The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the DoD Agency-Wide financial statements for FY 1999, the DoD Annual Statement of Assurance for FY 1999, and the DoD FMIP.

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## **Management Comments**

The Deputy Chief Financial Officer commented that DoD did not have time to review and determine the validity of assertions in the report. The DoD has a two-track approach to comply with new Federal accounting standards. The DoD does not expect to have systems necessary to meet these new requirements before the year 2000. The DoD has undertaken an interim track that includes the use of contractors to address many of the existing deficiencies. As a result, DoD expects to make incremental progress in addressing a number of financial management challenges that impact the ability to produce audited financial statements. The complete text of the comments is at Appendix C.

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# Review of Compliance With Laws and Regulations

## Reportable Noncompliances

Reportable 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 problems is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant.

Our objective was to assess the compliance with laws and regulations related to the DoD Agency-Wide financial statements for FY 1999 and not to express an opinion. Therefore, we do not express an opinion on compliance with laws and regulations. DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. We identified noncompliance issues related to the Federal Financial Management Improvement Act of 1996 (FFMIA), the Chief Financial Officers Act of 1990 (CFO), and the Government Performance and Results Act of 1993 (GPRA).

## Federal Financial Management Improvement Act of 1996

Under the FFMIA, section 3512, title 31, United States Code (31 U.S.C. 3512), we are required to report whether the agency's financial management systems substantially comply with Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger (USGSGL) at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in the OMB Bulletin, "Audit Requirements for Federal Financial Statements."

The results of our tests disclosed instances where the agency's financial management systems did not substantially comply with the three requirements. The Military Departments, Defense agencies, and DFAS are collectively responsible for the financial management systems that support DoD. The Military Departments and Defense agencies are responsible for the mixed data systems that supply approximately 80 percent of the data reported on the financial statements. These data are fed into the accounting and finance systems that are the responsibility of DFAS. DFAS used data from the financial management systems and other sources to compile the DoD Agency-Wide financial statements for FY 1999. DoD identified at least 168 systems that were critical to financial management. Because it is impractical to report the deficiencies for all 168 systems, this report gives examples of the most significant system deficiencies.

**Federal Financial Management System Requirements.** Federal financial management system requirements were established in OMB Circular No. A-127, "Financial Management Systems," July 23, 1993, which requires financial management systems to provide complete, reliable, consistent, timely, and useful information. To achieve this goal, DoD and other Federal agencies must establish

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and maintain a single, integrated financial management system. In addition, the Joint Financial Management Improvement Program has published a series of “Federal Financial Management System Requirements” that establishes standard requirements for Federal agencies’ integrated financial management systems. For FY 1999, the financial management systems that support DoD did not substantially comply with Federal financial management system requirements, as shown by the following.

- DoD did not have an integrated financial management system.
- The FMIP did not include all financial management systems that supported the Army WCF.
- Controls over access to financial management feeder systems for the Navy Working Capital Fund were not adequate to prevent unauthorized access to financial information.
- Financial management systems that supported the Air Force General Fund contained system control weaknesses. The primary control weaknesses were related to audit trails, access controls, configuration management, completeness, and accreditation.
- Adequate application controls, such as separation of duties, support for transactions, transaction controls, and data reconciliation were not in place for critical mixed systems for the Air Force Working Capital Fund.
- Transactions were not posted to the general ledger of accounts of the Other Defense Organizations-General Funds to which they should have been distributed.

**Federal Accounting Standards.** Federal agencies reporting under the Federal Financial Management Act of 1994 are to follow the Statements of Federal Financial Accounting Standards (SFFAS) agreed to by the Director, OMB; the Comptroller General of the United States; and the Secretary of the Treasury. Currently, there are 13 SFFAS and 3 Statements of Federal Financial Accounting Concepts (SFFAC). For FY 1999, the financial management systems that supported DoD did not substantially comply with Federal accounting standards, as shown by the following.

- DoD financial management systems did not properly account for assets and liabilities in accordance with SFFAS No. 1.
- DoD financial management systems did not value inventory in accordance with SFFAS No. 3.
- DoD financial management systems did not value PP&E in accordance with SFFAS No. 6.
- DoD financial management systems did not account for accounts receivable and accounts payable in accordance with SFFAC No. 1.

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**USGSGL at the Transaction Level.** The OMB requires Federal agencies to implement the USGSGL in their financial systems. The USGSGL must be implemented at the transaction level. Federal agencies are permitted to supplement their application of the USGSGL to meet agency-specific information requirements. However, agency standard general ledgers must maintain consistency with the USGSGL. For FY 1999, DoD finance and accounting systems lacked a standard, transaction-driven general ledger because the USGSGL was not fully implemented throughout the systems.

DoD has acknowledged that its financial management systems have significant procedural and systemic deficiencies, and has included a discussion of those deficiencies in previous Annual Statements of Assurance, the management representation letter for the DoD Agency-Wide financial statements for FY 1999, and the FMIP.

### **Chief Financial Officers Act of 1990**

The CFO Act, 31 U.S.C. 501, as amended by the Federal Financial Management Act of 1994, required DoD to prepare audited financial statements and submit them to OMB no later than March 1, 1999. In addition, the CFO Act required DoD to prepare a Five-Year Financial Management Plan describing activities that DoD will conduct during the next 5 years to improve financial management. We did not receive the financial statements in sufficient time to conduct all of our necessary audit procedures. Further, the financial statements we received were unauditable. The FMIP addressed the requirement in the CFO Act for a Five-Year Financial Management Plan.

### **Section 31, Title 31, United States Code**

The evaluation and reporting requirements of the Federal Financial Managers' Integrity Act of 1982 for an agency's internal accounting and administrative control systems were incorporated in 31 U.S.C. 3512. That section requires DoD to evaluate the systems and to annually report whether those systems are in compliance with 31 U.S.C. 3512. DoD fulfilled part of the FMFIA requirement by including the discussion of financial management system deficiencies, usually published as part of the Annual Statement of Assurance, in its FMIP. The Annual Statement of Assurance and the FMIP discussed systemic and nonsystemic internal control weaknesses and corrective measures under way to correct the weaknesses. However, as previously discussed, DoD has not completed its evaluation of all the finance, accounting, and feeder systems that have been identified for long-term use. Therefore, DoD was unable to completely report all system weaknesses. The Office of the USD(C) tasked the DoD Components with completing the remaining system evaluations by March 31, 2000.

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## Government Performance and Results Act of 1993

The GPRA, 31 U.S.C. 1101, was enacted primarily to improve the confidence of the American people in the capability of the Federal Government by systematically holding Federal agencies accountable for achieving program results. OMB Bulletin No. 97-01, as amended, requires that DoD include GPRA-related information in the financial statements, specifically:

- the Overview section of the DoD Agency-Wide financial statements is to contain a discussion of GPRA performance measures, and
- the program cost categories reflected in the Statement of Net Cost should be consistent with the DoD GPRA Performance Plan as published in the Annual Defense Report.

**Financial Statement Overview.** The CFO did not provide an adequate discussion of performance measures in the Overview. The Overview discussed only two goals: to reduce the number of accounting and finance systems and to achieve unqualified audit opinions on the financial statements. However, the Overview did not discuss the relationship with DoD corporate-level and 7 performance goals contained in the FY 1999 DoD GPRA performance plan. For example, the GPRA performance plan included the following performance goals:

- Maintaining sufficient airlift and sealift capability, with adequate prepositioning, to move military forces from the United States to any location in the world.
- Transforming U.S. forces for the future.
- Streamline the DoD infrastructure by redesigning the Department's support structure and pursuing practice reforms.

## Conclusion

Noncompliance with laws and regulations affected the DoD Agency-Wide financial statements for FY 1999. Many noncompliance issues were related to deficiencies in financial management systems and may not be fully corrected for a number of years. Other noncompliance issues were not specifically related to system deficiencies and should be correctable in the near future. All instances of noncompliance, including those not identified in this report, should be identified and addressed in the FMIP and related supporting documents, and DoD should plan for proper corrective actions. Improvements in compliance with laws and regulations are essential for DoD to improve financial management and reporting and will enhance the ability of DoD to achieve a favorable audit opinion. We reported similar instances of noncompliance with laws and regulations in FY 1998.

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## Appendix A. Audit Process

### Scope

**Statements Reviewed.** We examined the DoD Agency-Wide financial statements for FY 1999, the footnotes to the financial statements, the Overview, Required Supplemental Stewardship Information, and Required Supplemental Information. The financial statements consist of the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, Statement of Financing, and Statement of Custodial Activity. DoD did not provide the DoD Agency-Wide financial statements for FY 1999 in time for us to perform all of the necessary audit work.

**Scope Limitation.** The CFO did not provide sufficient or reliable information for us to evaluate management's assertions or verify amounts on the DoD Agency-Wide financial statements for FY 1999. The lack of timely financial statements is a scope limitation. Because of the scope limitation and deficiencies in the accounting system and internal controls, the scope of our work was not sufficient to allow us to render an opinion on the DoD Agency-Wide financial statements for FY 1999. To report on the internal controls and compliance with laws and regulations, we relied in part on audit work conducted by the Military Department audit agencies (the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency). Our combined audit efforts provide a reasonable basis for our results.

**Accounting Principles.** Accounting principles and standards for the Federal Government have been established and are under continuous development and refinement. The Federal Accounting Standards Advisory Board was established by OMB, the U.S. Department of the Treasury, and the General Accounting Office. On October 19, 1999, the American Institute of Certified Public Accountants recognized the Federal Accounting Standards Advisory Board as the body that establishes generally accepted accounting principles for Federal Government entities. Therefore, SFFAS issued by the Federal Accounting Standards Advisory Board are recognized as generally accepted accounting principles for applicable Federal Government entities.

Agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, as amended. The hierarchy is as follows: standards agreed to and published by the Director, OMB, the Secretary of the Treasury, and the Comptroller General of the United States; interpretations of SFFAS issued by OMB; requirements for the form and content of financial statements outlined in OMB Bulletin No. 97-01, as amended; and accounting principles published by other authoritative sources.

**Review of Internal Controls.** In planning and performing our audit, we considered DoD internal controls over financial reporting by obtaining an understanding of the agency's internal controls. We determined whether the controls had been placed in operation; we assessed control risk; and we performed tests of controls in order to determine our auditing procedures for the purpose of

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expressing our opinion on the financial statements. Our purpose was not to provide assurance on internal controls over financial reporting. Consequently, we do not express an opinion on DoD internal controls.

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls. Because of DoD material weaknesses in internal controls, we revised our audit approach to focus on specific internal controls. We obtained an understanding of management's process for evaluating and reporting on the internal controls and accounting systems and compared the material weaknesses in financial reporting, as reported in the entity's annual statement of assurance, to the material weaknesses and reportable conditions we identified. A copy of this report will be provided to the USD(C), who is the senior official in charge of management controls for DoD.

We performed a review of the performance information presented in the Overview of the DoD Agency-Wide financial statements for FY 1999. We obtained an understanding of the internal controls related to assertions about the existence and completeness of assets and determined whether they were placed into operation. We also reviewed the preparation of the performance information relating to the summarization and reporting of performance measure information in conformance with OMB Bulletin No. 97-01, as amended.

**Review of Compliance With Laws and Regulations.** DoD management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the DoD Agency-Wide financial statements for FY 1999 were free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations. A reportable noncompliance could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in the OMB Bulletin, "Audit Requirements for Federal Financial Statements." Our review also included the requirements referred to in the FFMIA. See Appendix B for a list of laws and regulations reviewed.

**DoD-Wide Corporate Level GPRA Goals.** In response to GPRA, the DoD has established 2 DoD-Wide corporate level performance objectives and 7 goals for meeting these objectives. This report pertains to achievement of the following objective and goal:

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

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



- 
- **Financial Management Functional Area: Objective:** Reengineer DoD business practices. **Goal:** Improve data standardization of finance and accounting data items. (FM-4.4)
  - **Financial Management Functional Area: Objective:** Strengthen internal controls. **Goal:** Improve compliance with FMFIA. (FM-5.3)

DoD is currently revising its approach to the GPRA implementation, and will implement new corporate lead goals and performance measures for FY 2001.

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

## Methodology

**Auditing Standards.** We conducted this financial statement audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD, and the OMB Bulletin, "Audit Requirements for Federal Financial Statements." Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal statements present fairly, in all material respects, in conformity with Federal accounting standards, the assets, liabilities, and net position; net costs; changes in net position; budgetary resources; reconciliation of net costs to budgetary obligations; and if applicable, custodial activity. To assess the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses, we relied on the guidelines suggested by the General Accounting Office and on our professional judgment.

**Audit Assistance.** The Military Department audit agencies assisted us by auditing various reporting entities and accounts. Except for deficiencies unique to the consolidation process, the information in this report is a summary of the most significant issues reported by the IG, DoD, and the Military Department audit agencies.

**Computer-Processed Data.** We could not rely on the computer-processed data used to prepare the DoD Agency-Wide financial statements for FY 1999. DoD financial management systems were unreliable; therefore, the financial statements were unauditable. DoD has candidly addressed deficiencies in its financial management systems in the Annual Statement of Assurance, the FMIP, and the management representation letter for FY 1999. Unreliable computer-processed data were used in preparing the financial statements and this report because they were the only financial data available. We continue to review the adequacy of existing and proposed financial management systems.

**Statistical Sampling Methods.** We relied on information in audit reports and summaries and in management reports. We did not use statistical sampling methods.

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**Audit Period and Locations.** We conducted the audit from September 1999 through February 2000 at various DoD activities, including DFAS and the Military Departments.

**Representation Letters.** We received the management representation letter from the USD(C) on February 16, 2000, and the legal representation letter from the General Counsel, DoD, on February 15, 2000. Exhibit 1 is the management representation letter and Exhibit 2 is the legal representation letter.

**Contacts During the Audit.** We visited or contacted individuals and organizations in DoD. Further details are available on request.

## **Summary of Prior Coverage**

The GAO and the IG, DoD, have conducted multiple reviews related to financial statement issues. GAO reports can be accessed on the Internet at <http://www.gao.gov>. IG, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil>.

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## Appendix B. Laws and Regulations Reviewed

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

Public Law 103-356, “Government Management Reform Act of 1994,”  
October 13, 1994 (Title IV of this Act may be cited as the “Federal Financial  
Management Act of 1994”)

Public Law 103-62, “Government Performance and Results Act of 1993,”  
August 3, 1993

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

National Defense Authorization Act for FY 1998

OMB Bulletin, “Audit Requirements for Federal Financial Statements”

OMB Bulletin No. 97-01, “Form and Content of Agency Financial Statements,”  
October 16, 1996, as amended November 20, 1998

OMB Circular No. A-127, “Financial Management Systems,” July 23, 1993

Statements of Federal Financial Accounting Concepts No. 2, “Entity and  
Display,” June 6, 1995

Statements of Federal Financial Accounting Concepts No. 1, “Objectives of  
Federal Financial Reporting,” September 2, 1993

Statements of Federal Financial Accounting Standards No. 9, “Deferral of the  
Effective Date of Managerial Cost Accounting Standards for the Federal  
Government in SFFAS No. 4,” November 3, 1997

Statements of Federal Financial Accounting Standards No. 8, “Supplementary  
Stewardship Reporting,” June 11, 1996

Statements of Federal Financial Accounting Standards No. 7, “Accounting for  
Revenue and Other Financing Sources,” May 10, 1996

Statements of Federal Financial Accounting Standards No. 6, “Accounting for  
Property, Plant, and Equipment,” November 30, 1995

Statements of Federal Financial Accounting Standards No. 5, “Accounting for  
Liabilities of the Federal Government,” December 20, 1995

Statements of Federal Financial Accounting Standards No. 4, “Managerial Cost  
Accounting Concepts and Standards for the Federal Government,” July 31, 1995

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Statements of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," October 27, 1993

Statements of Federal Financial Accounting Standards No. 2, "Accounting for Direct Loans and Loan Guarantees," August 23, 1993

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

Joint Financial Management Improvement Program, "Core Financial Systems Requirements," September 1995

Joint Financial Management Improvement Program, "Inventory System Requirements," June 1995

Joint Financial Management Improvement Program, "Framework for Federal Financial Management Systems," January 1995

Joint Financial Management Improvement Program, "Direct Loan System Requirements," December 1993

Joint Financial Management Improvement Program, "Guaranteed Loan System Requirements," December 1993

Joint Financial Management Improvement Program, "Seized/Forfeited Asset System Requirements," March 1993

Joint Financial Management Improvement Program, "Travel System Requirements," January 1991

Joint Financial Management Improvement Program, "Personnel/Payroll System Requirements," May 1990

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

DoD Instruction 7000.14-R, "DoD Financial Management Policy and Procedures," various dates

Additional laws and regulations were identified and discussed in other IG, DoD, and Military Department audit agency reports used to develop this report.

## Appendix C. Under Secretary of Defense (Comptroller) Comments



OFFICE OF THE UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100

FEB 22 2000

MEMORANDUM FOR ACTING INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Draft of a Proposed Audit Report, Internal Controls and Compliance With Laws and Regulations for the Department of Defense Agency-wide Financial Statements for Fiscal Year 1999, Project No. OFI-2115.01

This is the Office of the Secretary of Defense (Comptroller) response to the subject draft report. As the Department was afforded only one business day to comment on the audit report, the Department did not have sufficient time to review and provide comments on the report. Nor did the Department have sufficient opportunity to determine the validity of the assertions in the draft report.

The Department of Defense (DoD) is committed to improving its financial management processes and systems. The Department has adopted a two-track approach to comply with new federal accounting standards. The first track is to improve or replace its current systems so that they will meet new federal-wide standards. However, the Department does not expect to have systems necessary to meet these new requirements prior to the year 2003. In the meantime, the Department has undertaken a second interim track that includes the use of contractors to address many of the existing deficiencies. As a result, the Department expects to make incremental progress in addressing a number of financial management challenges that impact the DoD's ability to produce audited financial statements.

My staff point of contact for this matter is Mr. Thomas Tresslar. He may be reached by e-mail: [tresslat@osd.pentagon.mil](mailto:tresslat@osd.pentagon.mil) or by telephone at (703) 693-6502.

  
Nelson Toye  
Deputy Chief Financial Officer

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## **Appendix D. Report Distribution**

### **Office of the Secretary of Defense**

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

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Naval Inspector General  
Auditor General, Department of the Navy

### **Department of the Air Force**

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

### **Other Defense Organizations**

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

### **Non-Defense Federal Organizations**

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

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## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

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

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**Exhibit 1. Management Representation  
Letter**





COMPTROLLER

UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100

FEB 16 2000

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING  
DEPARTMENT OF DEFENSE

SUBJECT: Management Assurance Concerning Fiscal Year 1999 Department of Defense  
Agency-wide Financial Statements

This is in regard to your audit of the Fiscal Year (FY) 1999 Department of Defense (DoD) Agency-wide Financial Statements (Project No. OFI-2115). The financial statements include the Principal Statements (which are the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, the Statement of Custodial Activity, and the Notes to the Principal Statements) and the Required Supplementary Stewardship Information, as of September 30, 1999. This memorandum provides assertions central to your determination of (1) an opinion as to whether the financial statements and required supplementary stewardship information are presented fairly, in all material respects, in conformity with federal accounting standards, and (2) whether the agency's financial management systems substantially comply with federal financial management systems requirements, applicable federal accounting standards and the U.S. Government Standard General Ledger at the transaction level as of September 30, 1999.

I confirm, to the best of my knowledge and belief, that the following representations are accurate as of the date of this letter, and pertain to the period covered by the Principal Statements.

- 1) I am responsible for the fair presentation of the FY 1999 DoD Agency-wide Financial Statements in conformity with Federal accounting standards.
- 2) The FY 1999 DoD Agency-wide Financial Statements may not be presented in full conformity with federal accounting standards.
- 3) To the best of my knowledge, the Department has made available to you all financial records and related data, and communications from the Office of Management and Budget (OMB) concerning noncompliance with or deficiencies in financial reporting practices.
- 4) I have no knowledge of material transactions that have not been properly recorded in the accounting records underlying the financial statements or disclosed in the notes to the financial statements that are not a matter of public record.
- 5) To the best of my knowledge, the DoD has satisfactory title to all owned assets, including stewardship property, plant, and equipment; such assets have no liens or

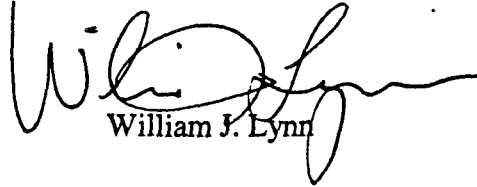
encumbrances, nor have any assets been pledged, that are not a matter of public record.

- 6) I have no plans or intentions, other than those previously disclosed, that may materially affect the carrying value or classification of assets and liabilities.
- 7) To the best of my knowledge, guarantees under which the DoD is contingently liable have been properly reported or disclosed.
- 8) Transactions for related parties (entities in which the Department has an ownership interest or significant management control) and related accounts receivable or payable, including assessments, loans, and guarantees may not all have been properly recorded and disclosed.
- 9) Intragovernmental transactions may not all have been explicitly disclosed or eliminated.
- 10) To the best of my knowledge, there are no:
  - a. Possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, that are not a matter of public record;
  - b. Material liability or gain or loss contingencies that are required to be accrued or disclosed, that have not been accrued or disclosed, that are not a matter of public record; or
  - c. Unasserted claims or assessments that are probable of assertion and that must be disclosed, that have not been disclosed.
- 11) To the best of my knowledge, the Department has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
- 12) I have no knowledge of material events or transactions that occurred subsequent to September 30, 1999, that have not been properly recorded in the Principal Statements, properly recorded in the Required Supplementary Stewardship Information, or disclosed in the notes thereto.
- 13) To the best of my knowledge, there has been no material fraud (intentional misstatements or omissions of amounts or disclosures in financial statements and misappropriation of assets that could have a material affect on the Principal Statements or the Required Supplementary Stewardship Information) nor any fraud involving management or employees who have significant roles in internal control, that is not a matter of public record.
- 14) I am responsible for ensuring the establishment and overseeing the maintenance of internal controls for financial management.

- 15) Pursuant to the Federal Managers Financial Integrity Act, I have assessed the effectiveness of DoD's internal controls in achieving the following objectives:
  - a. Reliability of financial reporting--properly recording, processing, and summarizing transactions to permit the preparation of the Principal Statements and Required Supplementary Stewardship Information in accordance with federal accounting standards, and the safeguarding of assets against loss from unauthorized acquisition, use or disposition.
  - b. Compliance with applicable laws and regulations--executing transactions in accordance with (i) laws governing the use of budgetary authority and other laws and regulations that could have a direct and material effect on the financial statements, and (ii) any other laws, regulations, and government-wide policies identified by the OMB in Appendix C of OMB Bulletin 98-08; and
  - c. Reliability of performance reporting--properly recording, processing, and summarizing transactions and other data that support reported performance measure to permit the preparation of performance information in accordance with criteria stated by management.
- 16) To the best of my knowledge, the controls in place on September 30, 1999, provided reasonable assurance that the foregoing objectives were met except for the material weaknesses discussed in the Department's FY 1999 Statement of Assurance.
- 17) I am responsible for implementing and maintaining financial management systems that comply substantially with federal financial management systems requirements contained in OMB Circular A-127, "Financial Management Systems," applicable federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.
- 18) I have assessed the financial management systems to determine whether they comply substantially with these federal financial management systems requirements. Our assessments were based on criteria established under OMB Circular A-127 and guidance issued by the OMB and included in Appendix D of OMB Bulletin 98-08.
- 19) As of the date of this letter, a number of the entity's financial management systems do not comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level, and did not do so as of September 30, 1999. The Department's FY 1999 Statement of Assurance provides information on the nature and extent of the noncompliance.
- 20) I am responsible for overseeing the DoD's compliance with laws and regulations applicable to the Department's financial statements.
- 21) I am not aware of any laws and regulations that have a direct and material effect on the determination of financial statement amounts that have not been disclosed.

- 22) To the best of my knowledge, I have disclosed all known instances of noncompliance with laws and regulations applicable to the Department's financial statements.

The point of contact for this matter is Dr. Fred Wulsin. He may be reached by e-mail: [wulsinf@osd.pentagon.mil](mailto:wulsinf@osd.pentagon.mil) or by telephone at (703) 697-3135.



William J. Lynn

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## **Exhibit 2. Legal Representation Letter**



GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE  
1600 DEFENSE PENTAGON  
WASHINGTON, D C. 20301-1600

FEB 15 2000

MEMORANDUM FOR THE ASSISTANT INSPECTOR GENERAL FOR AUDITING  
DEPARTMENT OF DEFENSE

SUBJECT: LEGAL REPRESENTATION LETTER FOR AUDITORS CONCERNING THE  
DEPARTMENT OF DEFENSE FISCAL YEAR 1999 DEFENSE-WIDE  
CONSOLIDATED FINANCIAL STATEMENTS

- \* REFERENCES:
- (a) USD(C) Memorandum dated November 29, 1999, Subject: Office of the Inspector General's Audit of the Fiscal Year 1999 Consolidated Department of Defense Financial Statements
  - (b) Legal Representation Letter for Auditors Concerning the Department of Defense Fiscal Year 1999 Defense-Wide Consolidated Financial Statements, dated December 28, 1999
  - (c) Department of the Army General Counsel Memorandum to the Auditor General, Department of the Army, dated February 7, 2000, Subject: Final Legal Representation Letter, Fiscal Year 1999 (FY99), Army Litigation and Contingencies (Tab 1)
  - (d) Department of the Navy General Counsel Memorandum for the Auditor General of the Navy, dated February 7, 2000, Subject: Final Update on Legal Representation Letter for the Fiscal Year 1999 Year-End Department of the Navy General Fund Financial Audit (Tab 2)
  - (e) Department of the Navy General Counsel Memorandum for the Auditor General, Department of the Navy, dated February 7, 2000, Subject: Final Update on Legal Representation Letter for the Fiscal Year 1999 Year-End Department of the Navy Working Capital Fund Financial Audit (Tab 3)
  - (f) Department of the Air Force General Counsel Memorandum to the Auditor General of the Air Force, dated February 1, 2000, Subject: Air Force Audit Agency Audit of the Air Force Fiscal Year (FY) 1999 Financial Statement-Final Report (Tab 4)

\*WE HAVE REMOVED ALL REFERENCES IN THIS LETTER FROM OUR AUDIT REPORT ON "INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR THE DOD-AGENCY WIDE FINANCIAL STATEMENTS FOR FY 1999"



- (g) Defense Logistics Agency General Counsel Memorandum to the Assistant Inspector General for Auditing, Office of the Inspector General, Department of Defense, dated February 2, 2000, Subject: Defense Logistics Agency Working Capital Fund for FY 1999 ( Tab 5)
- (h) Department of Defense General Counsel Memorandum to the Assistant Inspector General for Auditing, Department of Defense, Subject: Legal Representation Letter for Auditors Concerning the Department of Defense Fiscal Year 1999 Military Retirement Trust Fund Financial Statements (Tab 6)
- (i) American Bar Association Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975)

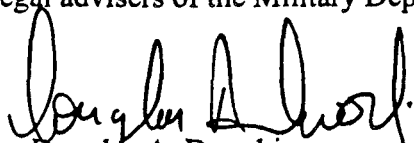
This memorandum responds to reference (a) which requested that my office provide a final legal representation letter with respect to the DoD-Wide Consolidated Financial Statements in addition to an interim legal representation letter that was provided to your office on December 28, 1999. A copy of that letter is attached.

This is to advise you that, except for the updated information provided by the Department of the Army in the attachment to reference (c) and the Air Force in reference (f), I am aware of no fact or circumstance between the date of the interim legal representation letter that was provided to your office on December 28, 1999 and the date of this letter that would call for any change to the December 28, 1999 interim legal representation letter or any of its attachments. Accordingly, reference (b), as modified by references (c) and (f), remains valid and may be considered to be the final updated legal representation letter for the DoD-Wide Consolidated Financial Statements.

#### Limitation on This Response

This response is limited by, and made in accordance with, the ABA Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975) (reference (i)). Without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of reference (i) and the accompanying Commentary (which is an integral part of this Statement). In addition, we do not interpret reference (a) to require or authorize the release of information subject to the attorney-client privilege or the work product doctrine, and in responding to reference (a) we have provided no information subject to that privilege or doctrine. Moreover, except as otherwise indicated in references (c) through (h),

the information set forth herein is as of February 11, 2000, and covers matters that existed as of September 30, 1999 and for the period September 30, 1999 to February 11, 2000, and I expressly disclaim any undertaking to advise you of changes which may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision after February 11, 2000. Finally, information reported herein relating to the Military Departments is reported as a courtesy and I hereby disclaim any responsibility for the accuracy or completeness of any information reported by the legal advisers of the Military Departments.

A handwritten signature in black ink, appearing to read "Douglas A. Dworkin". The signature is fluid and cursive, with a large initial "D" and "A".

Douglas A. Dworkin  
Acting General Counsel



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## **Exhibit 3. Auditor Opinion**



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-2885

February 16, 2000

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

SUBJECT: Independent Auditor's Report on the Department of Defense Agency-Wide  
Financial Statements for FY 1999 (Project No. OFI-2115)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibilities of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations. We attempted to audit the FY 1999 DoD Agency-Wide financial statements. As the Chief Financial Officer of DoD, the Under Secretary of Defense (Comptroller) is responsible for these financial statements, for establishing and maintaining internal controls, and for complying with laws and regulations applicable to DoD financial accounting and reporting. We did not audit the Army, Navy, and Air Force financial statements for FY 1999. The Military Department audit agencies attempted to audit those financial statements and issued disclaimers of opinion.

**Disclaimer of Opinion.** DoD did not provide us with the FY 1999 DoD Agency-Wide financial statements in time for us to perform all of the necessary audit work. Therefore, we did not verify the reported amounts. However, we identified deficiencies in internal controls and accounting systems related to General Property, Plant, and Equipment; Inventory; Environmental Liabilities; Military Retirement Health Benefits Liability; and material lines on the Statement of Budgetary Resources. Those deficiencies would have precluded an audit opinion. We also identified approximately \$2.3 trillion in adjustments to financial data used to prepare financial statements for the Army, Navy, and Air Force General Funds; the Army, Navy, and Air Force Working Capital Funds; Other Defense Organizations-General Funds; and Other Defense Organizations-Working Capital Funds. Those adjustments were not supported by adequate audit trails or by sufficient evidence to determine their validity.

The financial data reported on the FY 1999 financial statements for the Army, Navy, and Air Force General Funds and the Army, Navy, and Air Force Working Capital Funds were unauditible and represent a significant portion of the financial data reported on the DoD Agency-Wide financial statements for FY 1999.

Because the financial statements were not provided in a timely manner and internal control weaknesses, compilation problems, and financial management system deficiencies continued to exist, we were not able to perform adequate tests of the various line item amounts reported on the financial statements. As a result, we do not express an opinion on the DoD Agency-Wide financial statements for FY 1999. Except for the limitations on the scope of our work on the Principal Statements described above, we did our work in accordance with generally accepted Government auditing standards and the Office of Management and Budget (OMB) Bulletin, "Audit Requirements for Federal Financial Statements."

**Required Supplementary Stewardship Information.** The Stewardship Statement includes national defense property, plant, and equipment; heritage assets; stewardship land; non-Federal physical property; and research and development. This information is not required to be audited, and we did not audit and do not express an opinion on it. However, we applied limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with generally accepted accounting principles.

**Required Supplementary Information for Deferred Maintenance.** The supplementary information for Deferred Maintenance is not a required part of the basic financial statements, and we did not audit and do not express an opinion on this information. We did not apply procedures prescribed by professional standards because the official accounting guidance regarding the measurement criteria and reporting placement of deferred maintenance on the financial statements was not fully developed.

**Internal Controls.** Internal controls consist of the following components: control environment, risk assessment, control activities, information and communication, and monitoring. Effective implementation of these controls provides reasonable assurance that accounting data are accumulated, recorded, and reported properly by management and that assets are safeguarded. Management is responsible for internal controls. We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. However, these tests did not provide sufficient evidence to support an opinion on internal controls; therefore, we do not express an opinion on DoD internal controls.

DoD internal controls were not adequate to ensure that resources were properly managed and accounted for, that DoD complied with applicable laws and regulations, and that the financial statements were free of material misstatements. DoD internal controls did not ensure that adjustments to financial data were fully supported and that assets and liabilities were properly accounted for and valued. The material weaknesses and reportable conditions we identified were also reported in the management representation letter for the FY 1999 DoD Agency-Wide financial statements, the FY 1999 DoD annual statement of assurance, and the DoD Financial Management Improvement Plan. A separate report discusses internal control weaknesses in further detail.

**Compliance With Laws and Regulations.** Our objective was to assess compliance with laws and regulations related to the FY 1999 DoD Agency-Wide financial statements and not to express an opinion. Therefore, we do not express an opinion on compliance with laws and regulations.

DoD did not fully comply with laws and regulations that had a direct and material affect on its ability to determine financial statement amounts. DoD had not evaluated all critical finance, accounting, and mixed systems included in the DoD Financial Management Improvement Plan, as required by section 3512, title 31, United States Code (formerly the Federal Managers' Financial Integrity Act of 1982). As a result, DoD did not disclose the full extent of remedies, resources, or intermediate target dates needed to correct financial management system deficiencies. In addition, DoD did not comply with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended January 7, 2000, and Statement of Federal Financial Accounting Standard No. 4, "Managerial Cost Accounting Standards," effective October 1, 1997, which require financial data to be reported consistent with DoD performance goals and measures.

The results of our tests also disclosed instances where DoD financial management systems did not substantially comply with the three requirements of the Federal Financial Management Improvement Act of 1996. For example, DoD financial management systems

were not integrated; did not maintain adequate audit trails; did not value and depreciate property, plant, and equipment in accordance with Statement of Federal Financial Accounting Standard No. 6, "Accounting for Property, Plant, and Equipment," November 30, 1995; and did not incorporate the U.S. Government Standard General Ledger at the transaction level. Our work would not necessarily disclose all material weaknesses. A separate report discusses compliance issues in further detail.

*David K. Steensma*

David K. Steensma  
Deputy Assistant Inspector General  
for Auditing

## **Audit Team Members**

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report.

F. Jay Lane  
Richard B. Bird  
Jack L. Armstrong  
Cindi M. Miller  
Delpha W. Martin  
Leslie M. Barnes  
John E. Aber  
Cheri D. Givens  
Susanne B. Allen