November 7, 2003

Financial Management

Reliability of Construction-in-Progress in the U.S. Army Corps of Engineers, Civil Works, Financial Statements
(D-2004-017)

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Acronyms

CEFMS	Corps of Engineers Financial Management System
CIP	Construction-In-Progress
COEMIS	Corps of Engineers Management Information System
FMR	Financial Management Regulation
GAAP	Generally Accepted Accounting Principles
PP&E	Property, Plant, and Equipment
USACE	U.S. Army Corps of Engineers

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
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November 7, 2003

MEMORANDUM FOR COMMANDER AND CHIEF OF ENGINEERS, U.S. ARMY CORPS OF ENGINEERS

SUBJECT: Report on Reliability of Construction-in-Progress in the U.S. Army Corps of Engineers, Civil Works, Financial Statements (Report No. D-2004-017)

We are providing this report for review and comment. We considered management comments on a draft of this report when preparing the final report. The audit was performed to meet the requirements of 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.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The U.S. Army Corps of Engineers comments were partially responsive. We request that the Commander, U.S. Army Corps of Engineers, provide additional comments on Recommendation A.1.a. by January 6, 2004. If possible, please send management comments in electronic format (Adobe Acrobat file only) to Auddfs@dodig.osd.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

Management comments should indicate concurrence or nonconcurrence with each applicable finding and recommendation. Comments should describe actions taken or planned in response to agreed-upon recommendations and provide the completion dates of the actions. State specific reasons for any nonconcurrence and propose alternative actions, if appropriate. Management should also comment on the material management control weaknesses discussed in Appendix A.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. James L. Kornides at (614) 751-1400, extension 211 or Ms. Amy J. Frontz at (614) 751-1400, extension 213. See Appendix C for the report distribution. The team members are listed inside the back cover.

Paul J. Granetto

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Director
Defense Financial Auditing
Service

Office of the Inspector General of the Department of Defense

Report No. D-2004-017 **November 7, 2003**
(Project No. D2003FJ-0045)

Reliability of Construction-in-Progress in the U.S. Army Corps of Engineers, Civil Works, Financial Statements

Executive Summary

Who Should Read This Report and Why? DoD civil service and U.S. Army uniformed officers who use or are involved in the preparation of the financial reports required by the Chief Financial Officers Act should read this report. The report discusses the reliability of the Construction-in-Progress balance reported in the U.S. Army Corps of Engineers, Civil Works, FY 2003 and 2002 Comparative Consolidated Financial Statements.

Background. The audit was performed to meet the requirements of 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. The U.S. Army Corps of Engineers uses the Construction-in-Progress account to accumulate labor, material, and overhead costs for real property construction projects. Upon completion, the constructed property is either placed in service by the U.S. Army Corps of Engineers or transferred to another Federal or non-Federal agency that shared a portion of the costs. For FY 2002, General Property, Plant, and Equipment was the most significant asset reported on the U.S. Army Corps of Engineers, Civil Works, Financial Statements. Construction-in-Progress comprised $10.0 billion (27 percent) of the $36.9 billion FY 2002 General Property, Plant, and Equipment balance at net book value. The FY 2002 ending Construction-in-Progress balances represented the beginning balances for the FY 2003 financial statements. To evaluate the Construction-in-Progress beginning balance, we visited and gathered information from 38 U.S. Army Corps of Engineers locations for a statistical sample of 500 asset items valued at $5.8 billion.

Results. The U.S. Army Corps of Engineers materially overstated its Construction-in-Progress assets. We projected that the $10.0 billion Construction-in-Progress beginning balance for the U.S. Army Corps of Engineers, Civil Works, FY 2003 Principal Financial Statements was overstated by $4.3 billion. In addition, the U.S. Army Corps of Engineers reported Construction-in-Progress assets with negative balances totaling $41 million. Continued material misstatement of Construction-in-Progress will preclude the U.S. Army Corps of Engineers from gaining a favorable audit opinion on its financial statements. The U.S. Army Corps of Engineers should correct all negative balances, remove all costs related to expense-type events and completed projects from the Construction-in-Progress account, and issue revised guidance. Additionally, the U.S. Army Corps of Engineers should improve audit trails for Construction-in-Progress assets and disclose unsupported amounts (see finding A for details on the finding and recommendations).

The U.S. Army Corps of Engineers misreported costs relating to non-Federal cost share projects as Construction-in-Progress. As a result of this deficiency, we projected that the $10.0 billion Construction-in-Progress balance for the FY 2003 U.S. Army Corps of Engineers Financial Statements was overstated by $7.8 billion when combined with the deficiencies for Federal cost share items in finding A of this report. By capitalizing (recording and carrying forward expenditures for realization of benefits in one or more future periods) costs for non-Federal cost share projects as Construction-in-Progress, the U.S. Army Corps of Engineers significantly overstates the total assets and net position and understates current period expenses reported on the U.S. Army Corps of Engineers financial statements. The U.S. Army Corps of Engineers should expense all costs related to non-Federal cost share projects (see finding B for details on the finding and recommendation).

We identified material management control weaknesses related to the financial reporting of Construction-in-Progress. All of the recommendations in this report, if implemented, will improve the accuracy and reliability of U.S. Army Corps of Engineers financial reporting of Construction-in-Progress. A copy of the report will be provided to the senior official responsible for management controls.

Management Comments and Audit Response. The Commander, U.S. Army Corps of Engineers concurred with the findings and recommendations. The Commander agreed to make a statement-level adjustment to the FY 2003 financial statements for costs related to non-Federal cost share projects and fish mitigation studies. He also agreed to update U.S. Army Corps of Engineers capitalization guidance, improve audit trails in the Corps of Engineers Financial Management System, and issue document retention policy for source data supporting Construction-in-Progress values. However, the Commander did not agree to expense costs related to bank stabilization work and stated that it warrants capital asset treatment. We do not agree that bank stabilization work results in a capital asset for the U.S. Army Corps of Engineers because it represents maintenance of existing waterways. We request that the Commander, U.S. Army Corps of Engineers provide management comments on the final report by January 6, 2004. See the Finding sections of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

Management Actions. During the audit, the Commander, U.S. Army Corps of Engineers took numerous corrective actions to improve the accuracy of the Construction-in-Progress account (see finding A for a complete discussion of the management actions).

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Background

The audit was performed to meet the requirements of 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. The U.S. Army Corps of Engineers (USACE), Civil Works, reports General Property, Plant, and Equipment (PP&E) as a line item on the financial statements. For FY 2002, PP&E was the most significant asset category on the USACE financial statements, reported at a net value of $36.9 billion. The USACE uses the Construction-in-Progress (CIP) account to accumulate labor, material, and overhead costs for real property construction projects. Upon completion, the constructed property is either placed in service by USACE or transferred to another Federal or non-Federal agency that shared a portion of the costs. CIP represented $10.0 billion (27 percent) of the PP&E reported on the FY 2002 USACE Principal Financial Statements. The FY 2002 ending balances represent the beginning balances for the FY 2003 financial statements.

The USACE Civil Works mission includes: developing and managing the nation's water resources; protecting, restoring, and managing the environment; disaster response and recovery; and providing engineering and technical services to Federal entities, state and local governments, private firms, and international organizations. While performing its mission, USACE capitalizes as CIP all costs associated with the initial construction of a capital asset as well as any addition and/or betterment to an existing capital asset. The USACE capitalizes General PP&E assets at historical acquisition cost plus capital improvements when an asset has a useful life of 2 or more years, and when the acquisition cost equals $1 for real property and $25,000 for personal property.

The USACE uses the Corps of Engineers Financial Management System (CEFMS) for the financial reporting of CIP. During FY 1998, USACE completed the deployment of CEFMS to all its divisions, districts, centers, laboratories, and field offices. CEFMS replaced the Corps of Engineers Management Information System (COEMIS).

Objectives

Our overall audit objective was to determine the reliability of the USACE, Civil Works, CIP assets as presented in the General PP&E line item in the FY 2002 and 2001 comparative consolidated financial statements and whether the financial statements were prepared in accordance with Generally Accepted Accounting Principles (GAAP). We also reviewed the management control program as it related to the audit objective. The USACE was unable to provide audit-ready evidential material in time for us to complete the audit. Therefore, we continued our review based on agreed-upon procedures to establish beginning balances for the FY 2003 financial statements. See Appendix A for a discussion of the scope and methodology, our review of the management control program, and prior coverage related to the objectives.

A. Financial Reporting of CIP

The USACE materially overstated CIP assets. The CIP assets were overstated because USACE activities:

- erroneously capitalized expense-type events as CIP,
- did not transfer costs for completed construction projects out of CIP in the proper accounting period, and
- could not properly reconcile CIP costs maintained in CEFMS to originating source data.

As a result of these deficiencies, we projected that the $10.0 billion CIP beginning balance for the USACE, Civil Works, FY 2003 Principal Financial Statements was misstated by $4.3 billion. In addition, the USACE reported CIP assets with negative balances totaling $41 million. Continued material misstatement of CIP will preclude USACE from gaining a favorable audit opinion on its financial statements.

CIP Financial Reporting Criteria

Generally Accepted Accounting Principles. The GAAP for the financial reporting of PP&E is provided in the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," June 1996. The GAAP define PP&E as tangible assets that meet all of the following criteria: have an estimated useful life of 2 or more years, are not intended for sale in the ordinary course of business, and are intended to be used or available for use by the entity. Constructed PP&E is required to be recorded as CIP until placed in service.

The GAAP define Federal tangible assets as items owned by the Federal Government, which would have probable economic benefits that can be obtained or controlled by a Federal Government Entity. The GAAP define capitalization as recording and carrying forward expenditures for realization of benefits in one or more future periods. Expenses are defined as an outflow or depletion of assets during a period from providing goods, rendering services, or carrying out other activities related to an entity's programs and missions, the benefits from which do not extend beyond the present operating period.

DoD Accounting Policy for CIP. The DoD policy for the financial reporting of CIP is provided in DoD 7000.14-R, the DoD Financial Management Regulation (FMR), volume 4, chapter 6, "Accounting Policy and Procedures – Property, Plant & Equipment," August 2000. The DoD FMR defines general PP&E as tangible assets that meet all of the following criteria: have an estimated useful life of 2 or more years; are not intended for sale in the ordinary course of business; are intended to be used or available for use by the entity; and have an initial acquisition cost, book value, or fair market value that equals or exceeds the DoD capitalization threshold. For a constructed General PP&E asset, the cost to construct the asset shall be recorded as CIP until the asset is completed and available for use, whether or not actually placed in use at that time. According to the DoD FMR, the available-for-use date is not dependent on whether the constructed asset has been officially transferred or whether final payment has been made and the contract closed out. When the constructed asset is available for use, DoD policy requires the balance in the CIP account to be transferred to the appropriate General PP&E account. The DoD FMR definition of PP&E is consistent with GAAP.

USACE Accounting Policy for CIP. The USACE policy for the financial reporting of CIP is provided in USACE memorandum, "Revised Capitalization Guidance for Civil Works Personal Property," September 29, 1997. The USACE policy requires that all costs associated with the initial construction of a capital asset and all costs associated with the construction of an addition and/or betterment to an existing capital asset will be capitalized as CIP. The policy provides the following examples of costs that should be capitalized as CIP: land acquisition costs, relocation costs, engineering and design costs, supervision and administration costs, and actual contract and in-house construction costs. The policy requires expensing costs for construction-related activities that do not result in the creation of a capital asset, including related engineering and design and supervision and administration costs. The USACE policy provides the following examples of expense-type activities that should not be capitalized as CIP: beach replenishment; excavation or dredging of channels in existing waterways; excavation or dredging of navigation ports and harbors; removal of trees, brush, or debris in existing waterways; Section 202 non-structural activities (flood protection measures provided under the authority of Section 202 of Public Law 96-367); reconnaissance studies; special project reports; and feasibility studies (unless legislatively directed to be capitalized as CIP). USACE policy requires that General PP&E assets be capitalized at historical acquisition cost plus capital improvements when an asset has a useful life of 2 or more years, and when the acquisition cost equals $1 for real property and $25,000 for personal property.

CIP Assets Reviewed

USACE provided a universe of CIP assets extracted from CEFMS on September 30, 2002. The CIP universe reconciled to the corresponding trial balance for the FY 2002 financial statements. The CIP assets each represented the accumulation of capitalized CIP costs identified by a unique CEFMS work item code and/or funding account number. We segregated the universe into CIP assets with positive and negative values. We considered all negative balance items as errors because assets should not have negative balances. We reviewed a statistical sample of 500 positive-value CIP assets and a non-statistical sample of 21 negative-value CIP assets.

CIP Assets with Positive Values. We selected a statistical sample of 500 CIP assets valued at $5.8 billion from the positive-value universe of 17,801 CIP assets valued at $10.2 billion. The 500 CIP assets were located at 38 USACE activities. The statistical sample was developed to project the results at the aggregate level only. However, we did summarize the results of the 500 statistically sampled items by audit conclusion and as supported or unsupported. The statistically sampled CIP assets each could represent a number of separable asset elements. Therefore, a statistically sampled CIP asset could have portions that were supported, unsupported, and misclassified. CIP amounts that were not fully supported were considered as misstatements. Table 1 shows a summary of the audit results for the 500 statistically sampled items. See Appendix A for details on the statistical sampling plan and results. See the table in Appendix B for a breakout of the 500 sample items and CIP value by USACE activity reviewed.

Table 1. Audit Results for 500 Statistical Sample Items
($ in billions)

Audit Conclusion	No. Items	Amount Supported	Amount Misstated	Sample Value
Fully Supported[1]	166	$0.929	$0	$0.929
Expense-Type Events	104	0	0.792	0.792
Completed Projects	79	0.082	0.674	0.756
Part or All Unsupported	151	2.155	1.195	3.350
Total	**500**	**$3.166**	**$2.661**	**$5.827**

[1]Fully supported only includes the existence of source documentation to support CIP values in CEFMS for contract and USACE in-house costs not involving labor. Our scope was limited in that we did not physically verify the existence of the CIP assets and we did not validate labor, overhead, or capital interest calculations.

CIP Assets with Negative Values. Our review of the CIP universe provided by USACE showed 129 CIP assets with negative balances totaling $41 million. For the USACE activities already selected for review as part of the statistical sample, we also selected the CIP assets with large negative balances for review. We non-statistically selected a sample of 21 CIP assets with negative balances at 21 USACE activities.

Capitalization of Expense-Type Events

USACE activities were capitalizing expense-type events as CIP. For 104 sample items, CIP values totaling $792 million involved expense-type events that were improperly capitalized. The expense-type events involved dredging and widening of existing waterways, bank stabilization work, reimbursements to local sponsors, fish mitigation programs, studies, other miscellaneous expense-type events, and beach nourishment. Table 2 shows a breakout of the expense-type events. The DoD FMR states that if events result in the creation of capital assets, they should be recorded as such. These expense-type events do not result in the creation of capital assets and should be expensed when incurred rather than be capitalized as CIP.

Table 2. Breakout of Misclassified CIP		
Expense-Type Event	No. Items	Misstated CIP Value (in millions)
Dredging	33	$447
Bank Stabilization	17	175
Reimbursements	13	74
Fish Mitigation Programs	10	45
Studies	12	18
Miscellaneous	13	17
Beach Nourishment	6	16
Total	**104**	**$792**

Dredging and Widening of Existing Waterways. USACE activities did not comply with existing USACE policy and inappropriately capitalized costs relating to the dredging of existing waterways as CIP. For 33 sample items, approximately $447 million of dredging costs were capitalized. Dredging involves the removal of mud and/or rocks in order to widen or deepen an existing waterway. This event does not result in the construction of a capital asset. For example, the USACE Los Angeles District capitalized dredging costs related to the Los Angeles Harbor Project for four sample items valued at $176 million. The project involved the dredging of the Los Angeles Harbor, an existing waterway, and associated costs that should have been expensed when incurred.

Bank Stabilization. USACE activities inappropriately capitalized costs for stabilizing the banks of existing waterways as CIP. For 17 sample items, approximately $175 million of bank stabilization costs were capitalized. Bank stabilization involves fortifying the banks of existing waterways through the use of rocks (rip rap) or concrete mats (revetments). This event represents the maintenance of existing waterways and does not result in the construction of a capital asset. For example, the USACE Chicago District capitalized bank stabilization costs related to the Chicago Lake Shore Drive Preservation Project for four sample items valued at $56 million. The project involved placing concrete and steel revetments along the lakeshore to prevent erosion and protect the nearby streets. The bank stabilization costs should have been expensed when incurred. Existing USACE policy did not specifically identify bank stabilization work as an expense-type event.

Reimbursements to Local Sponsors. USACE activities inappropriately capitalized reimbursements to local sponsors for work completed as CIP. For 13 sample items, approximately $74 million of CIP costs involving sponsor reimbursements were capitalized. The work completed by the local sponsor did not result in the construction of USACE capital assets. For example, the USACE Sacramento District capitalized sponsor reimbursements related to the Natomas Flood Control Project for a sample item valued at $15 million. The Defense Appropriation Act for FY 1993 authorized construction of the Natomas Flood Control Project as defined by a 1991 USACE feasibility report. However, the Act authorized the local sponsor (Sacramento Area Flood Control Agency) to construct and receive reimbursement for the Federal share of the project costs. Although USACE was not involved in the construction, the Sacramento District capitalized $15 million reimbursed to the local sponsor as USACE CIP. The reimbursed costs should have been expensed when incurred. Existing USACE policy did not specifically identify reimbursements to sponsors for completed work as an expense-type event. However, USACE Headquarters provided informal guidance to the Pittsburgh District requiring that reimbursements to sponsors for completed work be expensed when incurred.

Fish Mitigation Programs. USACE activities inappropriately capitalized costs for fish mitigation programs as CIP. For 10 sample items, approximately $45 million of invalid CIP costs involving fish mitigation programs were capitalized. Fish mitigation programs involve lessening (mitigating) the impact of USACE projects on fish habitats and generally do not result in the construction of a capital asset. For example, the USACE Portland District capitalized fish mitigation program costs related to the Columbia River Fish Mitigation Program for seven sample items valued at $32 million. The costs primarily involved mitigation studies on juvenile fish passage and survival through USACE dams. The fish mitigation program costs should have been expensed when incurred. Existing USACE policy did not specifically identify fish mitigation programs as an expense-type event.

Studies. USACE activities did not comply with existing USACE policy and inappropriately capitalized costs relating to various studies (feasibility, environmental impact, etc.) as CIP. For 12 sample items, approximately $18 million of study costs were capitalized. The study costs did not involve the construction of a capital asset. For example, the USACE New York District capitalized study costs for three sample items valued at $15 million. The studies involved the Green Brook Upper Basin General Investigative Study, the Hackensack River Basin Flood Control Study, and the Hoosic River Congressional Feasibility Study. The studies involved costs that should have been expensed when incurred.

Other Miscellaneous Expense-Type Events. USACE activities inappropriately capitalized other miscellaneous expense-type events as CIP. For 13 sample items, approximately $17 million of costs involving other miscellaneous expense-type events were capitalized. These events did not result in the construction of USACE capital assets and included Section 202 non-structural work, environmental monitoring, costs to attend conferences unrelated to the construction of capital assets, and other miscellaneous expense-type events.

Beach Nourishment. USACE activities did not comply with existing USACE policy and inappropriately capitalized costs relating to the beach nourishment as CIP. For six sample items, approximately $16 million of beach nourishment costs were capitalized. Beach nourishment involves the replenishment of sand levels on eroded beaches. This event does not result in the construction of a capital asset. For example, the USACE New York District capitalized beach nourishment costs related to the Fire Island Inlet project for three sample items valued at $16 million. The project involved reformulation studies to determine the replenishment rate and the restoration of sand dunes for Barrier Island, which is located between the Shinecock and Moriches inlets on Long Island. The project includes approximately 83 miles of coastal beach protection and restoration and is categorized as a storm damage reduction project. The beach nourishment work involved costs that should have been expensed when incurred.

Transfer of Completed Projects

USACE activities did not transfer costs for completed construction projects out of the CIP account in the proper accounting period. For 79 sample items, CIP values totaling $674 million related to projects that were completed prior to September 30, 2002. The costs for the completed assets should have been transferred out of the CIP account. For the purposes of our audit, we developed three categories for the completed items: physically complete and sponsor maintained, physically and financially complete, and physically complete and USACE maintained.

Physically Complete and Sponsor Maintained. Approximately $467 million of invalid CIP costs related to assets that were physically completed and sponsor maintained prior to September 30, 2002. This deficiency involved 47 statistically sampled items. For example, a funded work item at the New England District contained $33 million of CIP costs for the Town Brook Local Flood Control Project. The funded work item originated in COEMIS and included costs for multiple phases of the project. Approximately $21 million of the CIP costs related to the second phase of the project, which was the construction of the Town Brook Tunnel. The Town Brook Tunnel was completed in 2001 and turned over by an official USACE letter to the local sponsor for operation and maintenance in January 2002. However, the costs to construct the tunnel remained in CIP on September 30, 2002. The costs for the completed asset should have been transferred out of the USACE CIP account upon completion and turnover to the local sponsor.

Physically and Financially Complete. Approximately $129 million of invalid CIP costs related to assets that were physically and financially completed prior to September 30, 2002. This deficiency involved 19 statistically sampled items. For example, a funded work item at the New Orleans District contained $27 million of CIP costs for the Mississippi River Gulf Outlet Project. The Mississippi River Gulf Outlet is a 76-mile manmade waterway that extends from New Orleans to the Gulf of Mexico. The Mississippi River Gulf Outlet project was completed in 1968. However, related costs remained in CIP on September 30, 2002. The costs for the completed project should have been transferred out of the CIP account upon physical and financial completion.

Physically Complete and USACE Maintained. Approximately $78 million of invalid CIP costs were related to USACE assets that were physically completed prior to September 30, 2002. This deficiency involved 13 statistically sampled items. For example, three sample items contained $69 million of CIP costs for the construction of multiple USACE assets at the Washington Aqueduct Division of the USACE Baltimore District. The three sample items accumulated CIP costs that were funded by Treasury Loans in 1997, 1998, and 1999. Multiple construction projects were being funded within the three sample items including the Basin Waste Recovery, Dalecarlia Pumping Station, Cabin John Bridge, Transmission and Storage Facilities, Dalecarlia Water Treatment Plant, McMillian Water Treatment Plant, Alternate Treatment Methods, and Water Quality Monitoring Projects. CIP costs of approximately $46 million for USACE projects were physically completed prior to September 30, 2002. The costs for the completed projects should have been transferred from the CIP account to the appropriate USACE real property account upon physical completion.

Unsupported CIP

USACE activities could not reconcile CIP costs maintained in CEFMS to originating source data. For 151 sample items, CIP values totaling $1.195 billion could not be verified to originating source data. The unsupported CIP value included projects that originated in COEMIS as well as projects that originated in CEFMS.

For our audit, we required the originating source data to support the CIP values reported in CEFMS. This was necessary because recent reviews by the General Accounting Office and the U.S. Army Audit Agency determined that the CEFMS could not be relied on for financial statement auditing purposes.[1]

Unsupported CIP Originating in COEMIS. Approximately $1.022 billion of the unsupported CIP value involved sample items with costs that originated in COEMIS, which was the USACE financial management system prior to FY 1998. During FY 1998, USACE completed the deployment of CEFMS to all its divisions, districts, centers, laboratories, and field offices. As part of the deployment, the CIP values were transferred from COEMIS to CEFMS. For the work items that originated in COEMIS, USACE activities had difficulty identifying CIP values to originating source data in a timely manner. For some of the larger COEMIS work items, USACE activities were unable to provide source data during the 6-month time period from our initial data request to the completion of our audit fieldwork.

For many of these work items, USACE activities were unable to identify the originating source data to support the CIP values currently maintained in CEFMS. For example, a funded work item, identified as "A00026," at the New Orleans District contained $72 million of CIP costs for the Pontchartrain Lake Flood Control Project. The funded work item originated in COEMIS. New Orleans District accounting personnel could not provide any originating source data to support the CIP values currently maintained in CEFMS. In addition, project management personnel explained that a majority of the costs probably related to completed portions of the project. A complete reconciliation will be required to identify costs that related to completed portions of the project and to identify costs to the appropriate separable asset elements still being constructed.

[1] General Accounting Office Report Number GAO-02-589,"Corps of Engineers Making Improvements, But Weaknesses Continue," June 10, 2002, and U.S. Army Audit Agency Report Number A-2002-0610-FFC, "Corps of Engineers Financial Management System General and Application Controls," September 30, 2002.

Unsupported CIP Originating in CEFMS. Approximately $173 million of the unsupported CIP value involved sample items with costs that originated in CEFMS. The sample items that originated in CEFMS were generally better supported than those originating in COEMIS. However, CEFMS did not provide a distinct audit trail to the originating source data. We worked with USACE activities to develop a CEFMS query that helped associate the CIP values in the CEFMS detailed cost ledger to supporting source data. However, some USACE activities were unable to execute the query. Additionally, some USACE activities were unable to provide originating source data to support a significant amount of the CIP values maintained in CEFMS. For example, two sample items at the Pittsburgh District contained CIP costs totaling $131 million for the Lower Monongahela River Project. Although a majority of the costs originated in CEFMS, the Pittsburgh District was unable to provide originating source data to support $111 million of the $131 million CIP value.

Negative Balance CIP Amounts

The CIP universe provided by USACE showed 129 items with negative balances totaling $41 million. We considered the entire $41 million balance to be in error because negative balances for asset accounts are an accounting anomaly. However, in an attempt to determine the causes of the negative balances, we selected and analyzed a non-statistical sample of 21 sample items with negative CIP balances at 21 USACE activities.

The negative CIP balances were caused by a number of factors. For example, a funded work item at the New Orleans District had a CIP balance of negative $1 million. The funded work item was transferred out of CIP on September 29, 1999. However, an accrual posted in the prior accounting period was reversed on October 9, 2001, which resulted in a negative balance. The negative balance remained in the financial ledgers on September 30, 2002. For many of the items, USACE activities had to seek assistance from the CEFMS programmers at the USACE Engineering and Support Center, Huntsville, Alabama. Table 3 shows a complete listing of the factors resulting in negative CIP balances for the 21 sample items reviewed.

Table 3. Reasons for Negative CIP Balances

Reason for Negative Balance	No. Items
Error resulting from asset capitalization	6
COEMIS to CEFMS conversion	5
No specific cause identified	5
Error resulting from cost transfer process	2
Accrual reversed subsequent to asset capitalization	2
Error resulting from reversal of capital interest charges	1
Total	**21**

Impact of Misreported CIP

We projected that the $10.0 billion CIP beginning balance for the USACE, Civil Works, FY 2003 Principal Financial Statements was overstated by $4.3 billion. This represents a material management control weakness because the $4.3 billion misstatement represents approximately 43 percent of the CIP account balance. The projections were calculated using the sample results on the CIP assets that we determined had values that were in error or were not adequately supported. See Appendix A for details on the statistical sampling plan and results.

The misclassified Construction-in-Progress significantly overstated the total assets and net position and understated expenses reported on the U.S. Army Corps of Engineers financial statements. Continued material misstatement of CIP will preclude USACE from gaining a favorable audit opinion on its financial statements.

Corrective Actions

During the audit, USACE headquarters took actions to correct some of the errors we identified in the CIP account. Specifically, USACE provided the results of our 500 sample items to the USACE field sites for corrective actions. In addition, USACE headquarters sent two memorandums to its field sites tasking them to close out all dormant CIP projects, to expense all costs that did not result in the creation of a capital asset, and to correct all negative CIP balances. Further, USACE headquarters revised its existing CIP accounting policy to partially correct the deficiencies identified by our audit and provided a draft version to its field sites for implementation. These corrective actions represent positive steps towards achieving an accurate CIP balance.

Conclusion

The $10 billion USACE CIP account represents a significant portion of the total assets reported on the USACE financial statements. The $4.3 billion of projected erroneous and unsupported CIP costs identified by this report greatly exceeds the materiality threshold generally established for financial statement audits. Misclassified CIP costs impact the total assets, net position, and expenses reported on the USACE financial statements. In addition, for CIP assets that will remain as USACE property upon completion, the costs accumulated in CIP will serve as a basis for the value of the real property when it is placed in service. Therefore, it is imperative that CIP assets be presented accurately and in accordance with GAAP. This will significantly aid USACE efforts to achieve a favorable audit opinion on its financial statements.

Recommendations, Management Comments, and Audit Response

A.1. We recommend that the Commander, U.S. Army Corps of Engineers perform a comprehensive review of the Construction-in-Progress account and perform the following corrective actions:

a. Expense all costs that do not result in the creation of a capital asset.

b. Transfer out all costs related to completed projects.

c. Reconcile costs originating in the Corps of Engineers Management Information System to the appropriate separable asset elements of valid ongoing construction projects.

d. Quantify and disclose all costs originating in the Corps of Engineers Management Information system that cannot be readily supported by originating source data.

e. Correct all negative balances.

Management Comments. The Commander, U.S. Army Corps of Engineers concurred with exceptions. The Commander stated that he considers bank stabilization work as a capital asset warranting Construction-in-Progress accounting treatment because it is part of the overall Mississippi River master plan for flood control cost avoidance, maintenance of the navigable waterways for commerce, and maintenance of or enhancement of property values. The Commander also stated that Congress mandated Construction-in-Progress accounting for Columbia and Snake River system Fish Mitigation study costs. However, the Commander agreed to make a statement-level adjustment to the FY 2003 financial statements for costs related to fish mitigation studies. In addition, the Commander stated that aggressive actions were initiated in April 2003 to correct the other deficiencies identified in the Construction-in-Progress account. Specifically, data mining with specially developed queries were complimented with information papers and a monthly upward reporting process. Internal Review auditors have monitored and assisted the program managers and accountants as they cleansed the Construction-in-Progress accounts. The Commander stated that corrective actions were completed on September 30, 2003.

Audit Response. We do not agree with the Commander’s comments concerning the treatment of bank stabilization. The Commander did not identify actions to expense costs related to bank stabilization work. We agree with the Commander’s comments that bank stabilization work represents maintenance of the navigable waterways but do not agree that it results in a capital asset that economically benefits the U.S. Army Corps of Engineers. The Mississippi River is not reported as an asset on the U.S. Army Corps of Engineers Balance Sheet. Therefore, maintenance on its banks should not be capitalized. We request that the Commander, U.S. Army Corps of Engineers provide management comments on the final report by January 6, 2004.

A.2. We recommend that the Commander, U.S. Army Corps of Engineers reissue existing Corps of Engineers policy for Construction-in-Progress financial reporting to:

a. Clarify that the following expense-type events not resulting in the creation of a capital asset should be expensed in the period incurred: reimbursements to local sponsors for completed work, fish mitigation programs, and bank stabilization work (including revetment mats).

b. Require the transfer of completed projects or separable asset elements from the Construction-in-Progress account in a manner consistent with the DoD Financial Management Regulation.

Management Comments. The Commander, U.S. Army Corps of Engineers concurred and stated that interim guidance was issued in the form of information papers. Additionally, the Commander stated that Engineering Regulation 37-2-10 policy will be updated based on the corrective action guidance that was issued to subordinate commands in response to Recommendation A.1. The Commander estimated that the corrective actions would be completed by June 30, 2004.

A.3. We recommend that the Commander, U.S. Army Corps of Engineers modify the Corps of Engineers Financial Management System to allow for a distinct audit trail identifying Construction-in-Progress values to all originating source data.

Management Comments. The Commander, U.S. Army Corps of Engineers concurred and stated that the Corps of Engineers Financial Management System Development Team has developed the requested report.

A.4. We recommend that the Commander, U.S. Army Corps of Engineers issue policy requiring U.S. Army Corps of Engineers activities to retain originating source data to support Construction-in-Progress values maintained in the Corps of Engineers Financial Management System.

Management Comments. The Commander, U.S. Army Corps of Engineers concurred and stated that interim guidance was issued in the form of information papers. Additionally, the Commander stated that action will be taken to have his Headquarters Corporate Information Records Management Office issue updated guidance regarding the need for long-term retention valuation documents related to capital assets. The Commander estimated that the corrective actions would be completed by June 30, 2004.

B. Financial Reporting of Non-Federal Cost Share Projects

The USACE misreported costs relating to non-Federal cost share projects as CIP. The costs were misreported because USACE believed that all assets under construction that met the USACE capitalization criteria, regardless of the ultimate owner, were required to be financially reported as CIP on the USACE financial statements until completed. However, the USACE methodology did not comply with GAAP. As a result of this deficiency, we projected that the $10.0 billion CIP beginning balance for the FY 2003 USACE Financial Statements was overstated by $7.8 billion when combined with the deficiencies for Federal cost share items in finding A of this report. By capitalizing costs for non-Federal cost share projects as CIP, USACE significantly overstates the total assets and net position and understates current period expenses reported on the USACE financial statements.

Non-Federal Cost Share Projects

A significant portion of the USACE mission is to provide engineering and construction management support for non-Federal entities. In many cases, the non-Federal entity (also referred to as the local sponsor) shares a portion of the costs up front and throughout the project. The USACE uses its CIP account to accumulate labor, material, and overhead costs for these non-Federal cost share projects. Upon completion, the constructed property is generally transferred without reimbursement to the non-Federal agency that shared a portion of the costs. The constructed property is not recorded as USACE real property and does not result in a future economic benefit to the USACE. For purposes of our audit, we categorized these projects as non-Federal cost share projects.

Asset Capitalization Criteria

GAAP for Asset Capitalization. GAAP define fixed assets as tangible property that is to be used in a productive capacity within the business and will benefit the enterprise for a period of more than 1 year. It is necessary to allocate the cost of these assets to the future periods benefited in accordance with the matching principle. The matching principle dictates that efforts (expenses) be matched with accomplishments (revenues) whenever it is reasonable and practical to do so. The cost of an asset expected to provide benefits for more than one accounting period must be allocated over all of the accounting periods during which the asset is used because the asset contributes to the generation of revenue throughout its useful life. This is accomplished by depreciating the asset over a predetermined period of time that it is expected to provide benefits. When no future benefit is anticipated or no connection with revenue is apparent, costs are generally charged to the current period as expenses.

DoD Asset Capitalization Policy. The DoD asset capitalization policy is defined in DoD 7000.14-R, the DoD FMR, volume 4, "Accounting Policy and Procedures," September 1999. The DoD FMR defines a DoD asset as an economic resource available to DoD that has three essential characteristics: it has a capacity to contribute to the accomplishment of the DoD mission (also referred to as service potential), DoD can use the asset or control access to the asset, and the transaction or event giving rise to DoD right to, or financial control over, the asset has already occurred.

Specific guidance on the financial reporting of DoD CIP is provided in DoD 7000.14-R, the DoD FMR, volume 4, chapter 6, "Property, Plant and Equipment," August 2000. According to the DoD FMR, CIP costs are accumulated by USACE when they are responsible for the construction. The DoD Component that is to receive the constructed property shall report CIP amounts on their financial statements, regardless of what type of funds were used to fund the construction. Such CIP balances shall be provided annually by USACE to the appropriate reporting DoD Component along with supporting documentation in sufficient detail to reconcile the CIP balances by project and funding source. In addition, USACE is required to make any additional data available to the reporting DoD Component upon request. Although the DoD FMR does not separately address projects constructed for non-Federal entities, the guidance does indicate that the agencies that will ultimately receive the constructed property should record the related CIP costs on their books. The USACE is responsible for providing the CIP balances to the appropriate agencies on an annual basis.

USACE Asset Capitalization Policy. The USACE policy for the financial reporting of CIP is provided in USACE memorandum, "Revised Capitalization Guidance for Civil Works Personal Property," September 29, 1997. The USACE policy requires that all costs associated with the initial construction of a capital asset and all costs associated with the construction of an addition and/or betterment to an existing capital asset will be capitalized as CIP. The USACE policy does not distinguish between projects that will remain as Federal Government property and projects that will be transferred to a non-Federal sponsor upon completion.

Capitalization of Non-Federal Cost Share Projects

The USACE erroneously capitalized costs relating to non-Federal cost share projects as CIP. In the audit sample, 345 items had CIP costs valued at $3.6 billion related to non-Federal cost share projects. For example, a funded work item, identified as "A00069," at the Philadelphia District contained $15 million of CIP costs for the Molly Ann's Brook local flood control protection project. Including our sample item, total project costs of approximately $28 million were capitalized as USACE CIP at September 30, 2003. The Molly Ann's Brook is a tributary of the Passaic River located in the municipalities of Haledon, Prospect Park, and Patterson, New Jersey. The project involves 2.5 miles of channel modification, bridge modifications, and the removal of a condemned building. The project started in 1993 and upon completion will be transferred to the non-Federal sponsor, the New Jersey Department of Environmental Protection, for continued operation and maintenance. This project does not involve the construction of any assets that will be owned or that will provide future economic benefits to the USACE. The non-Federal sponsor purchased the property containing the condemned building and the County of Passaic New Jersey owns the bridge requiring repairs. Although these projects serve an important purpose for the non-Federal sponsors, they should not be recorded as CIP on the USACE financial statements.

USACE believed that all assets under construction meeting the USACE capitalization criteria, regardless of the ultimate owner, were required to be financially reported CIP on the USACE financial statements until completed. USACE headquarters representatives stated that they capitalized the costs for non-Federal cost share projects as CIP because they wanted to maintain consistency with the reporting of Military CIP. Additionally, USACE representatives stated they believed that they had a legal responsibility for the assets being constructed and were required to capitalize the costs as CIP. However, the USACE methodology did not comply with GAAP because the constructed property does not result in a future economic benefit to the USACE. Additionally, the USACE methodology for reporting Military CIP did not comply with the DoD FMR, which requires the DoD Component that is to receive property constructed by USACE to report CIP amounts on their financial statements.

Impact on Financial Statements

We projected that as a result of capitalizing non-Federal cost share projects, the $10.0 billion CIP balance reported on the FY 2002 USACE Financial Statements was misstated by $7.8 billion when combined with the impact of the deficiencies in finding A of this report.

Capitalization of non-Federal cost share projects as USACE CIP significantly overstates the total assets and net position and understates current period expenses reported on the USACE financial statements. In the case of non-Federal cost share projects, there is no anticipated future benefit to USACE. Upon completion, the constructed asset is transferred to a non-Federal sponsor without reimbursement. There is no connection to future revenues. Therefore, the costs related to non-Federal cost share projects should be expensed when incurred.

In the Analysis of Financial Statements section of the FY 2002 USACE, Civil Works, Principal Financial Statements, net position (equity) is described as the residual interests of the assets of the entity that remains after deducting its liabilities. For FY 2002, USACE, Civil Works, net position was described as amounting to $40.8 billion and as representing almost a $2 billion, or 5 percent, increase over FY 2001. If the $7.8 billion of errors resulting from non-Federal cost share assets were considered, the FY 2002 USACE, Civil Works, net position would be reduced to $33 billion.

Recommendation, Management Comments, and Audit Response

B. We recommend the Commander, U.S. Army Corps of Engineers expense all costs for constructing assets that will be transferred to a non-Federal sponsor upon completion.

Management Comments. The Commander, U.S. Army Corps of Engineers, partially concurred and agreed to make a statement-level adjustment to the FY 2003 financial statements for costs related to non-Federal cost share projects. However, the Commander stated that cost related to non-Federal cost projects warrant Construction-in-Progress accounting treatment and that an independent review is necessary to resolve the action for FY 2004. In addition, the Commander stated that in the near future his staff plans to participate with the DoD Comptroller in discussions the Federal Accounting Standards Advisory Board regarding the accounting treatment for non-Federal cost share projects.

Audit Response. The Commander's comments are responsive for FY 2003 financial reporting. We plan to address this issue further as part of our FY 2004 audit and will consider any future decisions by the Federal Accounting Standards Advisory Board.

Appendix A. Scope and Methodology

The audit was performed to meet the requirements of 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. For this part of the audit, we determined the reliability of the USACE, Civil Works, CIP assets as presented in the General PP&E line item in the FY 2002 and 2001 comparative consolidated financial statements and whether the financial statements were prepared in accordance with GAAP.

We performed the audit at USACE headquarters and field locations. Specifically, we analyzed the CIP values for a statistical sample of 500 CIP assets valued at $5.8 billion. We accomplished our audit at 38 USACE activities using a combination of site visits and data call methodology. We determined whether the CIP values were accurately reported in accordance with GAAP and were supported by originating source data.

We used statistical sampling methods to test USACE management assertions regarding the valuation and existence of the CIP account. We interviewed USACE Project Managers and Resource Management personnel at each activity to obtain background and status on each project reviewed. We also reviewed project fact sheets, pictures, and other related documentation for the various projects. Additionally, we reviewed all applicable documentation supporting the CIP values including, but not limited to: contractor pay estimates, contractor invoices, travel voucher settlements, and Military Interdepartmental Purchase Requests.

Our scope was limited in that we did not physically verify the existence or completeness of the CIP assets. In addition, we did not validate the labor and overhead values or the capital interest calculations for each CIP project. We performed this audit from September 2002 through June 2003 in accordance with generally accepted government auditing standards.

USACE provided a universe of CIP assets extracted from CEFMS on September 30, 2002. The CIP assets each represented the accumulation of capitalized CIP costs identified by a unique CEFMS work item code and/or funding account number. We reconciled the $10.118 billion CIP universe provided by USACE to the $10.043 billion CIP balance reported on the financial ledgers and identified a $75 million variance. After we had selected the statistical sample, USACE informed us that they had extracted the CIP universe prior to the close of business on September 30, 2002. USACE provided the revised universe, and we reconciled it to the financial ledgers without a material variance. We segregated the universe in to CIP assets with positive and negative values. We used a non-statistical sampling methodology to evaluate the CIP assets with negative CIP balances totaling $41 million. We used a statistical sampling methodology to evaluate the CIP assets with positive CIP balances totaling $10.159 billion.

Sample Design. The Inspector General, DoD, Quantitative Methods Division used a stratified variable sampling methodology and a 95 percent confidence level to select a statistical sample of CIP assets from a universe of 17,801 CIP assets valued at $10.159 billion. The sample was composed of 500 CIP assets, valued at $5.827 billion. A breakout of the 500 sample items and CIP value by USACE activity reviewed is provided in Appendix B.

Sample Results. Inspector General, DoD statisticians calculated the following projections for the $10.159 billion CIP balance USACE reported for FY 2002. The projections were calculated using the sample results we provided on the CIP assets that we determined had values that were misclassified or were not adequately supported.

Projections Not Considering Non-Federal Cost Share Projects as Errors. We are 95 percent confident that the FY 2002 USACE CIP balance was between $4.033 billion and $4.633 billion overstated. These results did not consider CIP costs for non-Federal cost share projects as errors.

	95 Percent Confidence Interval		
Non-Cost Share	Lower Bound	Point Estimate	Upper Bound
Not Supported or Misclassified	$4.033 billion	$4.333 billion	$4.633 billion

Projections Considering Non-Federal Cost Share Projects as Errors. We are 95 percent confident that the FY 2002 USACE CIP balance was between $7.052 billion and $8.128 billion overstated. These results considered CIP costs for non-Federal cost share projects as errors. The errors resulting from non-Federal cost share items were combined with the errors resulting from Federal cost share items identified in finding A of this report.

	95 Percent Confidence Interval		
Cost Share	Lower Bound	Point Estimate	Upper Bound
Not Supported or Misclassified	$7.052 billion	$7.815 billion	$8.128 billion

Use of Computer-Processed Data. We relied on computer-processed data from the CEFMS to determine the FY 2002 CIP universe for statistical sampling purposes. We did not test the CEFMS general and application controls. We were able to reconcile the FY 2002 CEFMS CIP universe to the USACE trial balance for the corresponding period ending September 30, 2002, without a material variance. Additionally, we performed other tests on the data to determine the accuracy and reliability of the CIP account balance. For our audit, we required the originating source data to support the CIP values reported in CEFMS. This was necessary because recent reviews by the General Accounting Office and the U.S. Army Audit Agency determined that the CEFMS could not be relied on for financial statement auditing purposes.

Use of Technical Assistance. The Technical Director, Branch Chief, and Operations Research Analysts from the Inspector General, DoD, Quantitative Methods Division provided assistance in developing the statistical sample and calculating the statistical projections.

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

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require 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 the controls.

Scope of the Review of the Management Control Program. We reviewed the adequacy of USACE management controls over the financial reporting of CIP. We reviewed management's self-evaluation applicable to those controls. We reviewed the FY 2002 Annual Statement of Assurance issued by USACE to determine whether the issues addressed in this report had been reported as material management control weaknesses.

Adequacy of Management Controls. We identified material management control weaknesses, as defined by DoD Instruction 5010.40, related to the financial reporting of CIP. The details of the management control weaknesses are provided in detail in the Finding sections of this report. All of the recommendations in this report, if implemented, will improve the accuracy and reliability of USACE financial reporting of CIP. A copy of the report will be provided to the senior official responsible for USACE management controls.

Adequacy of Management's Self-Evaluation. USACE officials did not identify CIP financial reporting as an assessable unit and, therefore, did not identify or report the material management control weaknesses identified by the audit.

Prior Coverage

During the last 5 years, the General Accounting Office, Inspector General, DoD, and the U.S. Army Audit Agency have issued several reports discussing the USACE, Civil Works, financial statements. Unrestricted General Accounting Office reports can be accessed over the Internet at http://www.gao.gov. Unrestricted Inspector General of the Department of Defense (IG DoD) reports can be accessed at http://www.dodig.osd.mil/audit/reports. Unrestricted Army Audit Agency reports can be accessed at https://www.aaa.army.mil/reports/.htm, which is accessible on the extranet to military domains and General Accounting Office only.

Appendix B. Breakout of 500 Statistical Sample Items by Activity Reviewed

USACE Activity Reviewed	No. Items	CIP Value
Los Angeles District	34	$1,035,048,245
Louisville District	33	634,413,997
New Orleans District	63	510,654,654
Portland District	25	441,331,423
Baltimore District	14	303,549,744
New York District	40	280,477,110
Nashville District	15	252,583,566
Jacksonville District	27	221,654,628
Pittsburgh District	16	221,027,836
Little Rock District	7	198,669,961
Galveston District	20	179,619,397
Walla Walla District	9	171,266,386
Memphis District	10	149,879,898
Sacramento District	24	143,776,108
Chicago District	16	134,721,583
Huntington District	14	130,422,861
Omaha District	14	122,543,399
Vicksburg District	18	111,726,859
Washington Aqueduct Division	3	69,197,512
New England District	5	65,079,425
St. Paul District	8	64,550,894
Kansas City District	5	54,529,625
Tulsa District	7	50,960,384
Norfolk District	4	43,479,024
Mobile District	9	39,786,678
Fort Worth District	5	30,754,278
Seattle District	7	24,811,440
St. Louis District	15	23,323,216
Honolulu District	5	21,101,232
Albuquerque District	7	17,662,468
Philadelphia District	2	16,526,182
USACE Headquarters	5	16,431,191
Alaska District	1	16,139,650
Wilmington District	2	13,371,165
San Francisco District	3	6,715,495
Rock Island District	4	5,334,488
Vicksburg Engineering Research & Development Center	2	2,098,000
Detroit District	2	1,990,079
Total	**500**	**$5,827,210,081**

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Assistant Secretary of the Army (Civil Works)
Commander, U.S. Army Corps of Engineers
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Unified Command

Inspector General, U.S. Joint Forces Command

Non-Defense Federal Organization

Office of Management and Budget

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

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member (cont'd)

House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform

House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform

House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

U.S. Army Corps of Engineers Comments

DEPARTMENT OF THE ARMY
U.S. ARMY CORPS OF ENGINEERS
WASHINGTON, D.C. 20314-1000

REPLY TO
ATTENTION OF:

CEIR (36-2b) 3 October 2003

MEMORANDUM FOR Director, Defense Auditing Service, Inspector General Department of Defense. 400 Army Navy Drive, Arlington VA 22202

SUBJECT: Draft Report on the Reliability of Construction - in - Progress (CIP) in the U.S. Army Corps of Engineers (USACE), Civil Works (CW), Financial / Statements (Project No. D2003FJ-0045)

1. The USACE response to each Department of Defense Inspector General (DoDIG) report recommendations follows:

2. **Finding A - Financial Reporting of CIP**

a. **DoDIG Recommandation A.1**. We recommend that the Commander USACE perform a comprehensive review of the CIP account and perform the following corrective actions:

(1) Expense all costs that do not result in the creation of a capital asset.

(2) Transfer out all costs related to completed projects.

(3) Reconcile costs originating in the Corps of Engineers Financial Management System (CEFMS) to the appropriate separable asset elements of valid on-going construction projects.

(4) Quantify and disclose all costs originating in CEFMS that cannot be supported by originating source data.

(5) Correct all negative balances.

b. **USACE Additional Facts.**

(1) **Bank Stabilization** includes Mississippi River and Tributary (MR&T) work involving revetment mats and rip rap. The useful life and economic value of these engineered structures are an integral part of the overall Mississippi River master plan for flood control cost avoidance, maintenance of the navigable waterway for commerce, and maintaining or enhancing of property values. Public Law 84-99 directs USACE to provide disaster relief to the nation for all natural disasters caused by flooding. The revetment mats decrease the possibility of severe flooding, assist with maintaining adequate river depth for water borne commerce, and maintains or increases the property values of the nearby land. In addition, we believe these items meet the Federal Accounting Standards Advisory Board (FASAB) capitalization definition of "tangible assets that (1) have an estimated life of 2 or more years, (2) are not intended for sale in the ordinary course of business, and (3) are intended to be used or available for use by the

CEIR (36-2B)
SUBJECT: Draft Report on the Reliability of Construction - in - Progress (CIP) in the U.S. Army Corps of Engineers (USACE), Civil Works (CW), Financial / Statements (Project No. D2003FJ-0045)

entity." Therefore, these items meet Generally Accepted Accounting Principles (GAAP) capitalization criteria and warrant capital asset treatment in CIP.

(2) **Cost Shared Water Resource Development Act (WRDA) Projects** with Non-Federal Agencies (NFA) are currently accounted for in CIP. The reasons for this USACE policy are discussed in detail in our response to the report's Finding B, which is below.

(3) **Fish Mitigation Study Costs** for the Columbia and Snake River systems are being accounted for as directed by Congress in a series of Appropriation Committee reports. These reports direct that the costs associated with fish mitigation studies "shall not be allocated until the conclusion of the mitigation analysis" (E.g., S. Rep. 102-344, at 33 (1992)).

c. **USACE Command Response.** We concur with the following exceptions: we consider the MR&T Bank Stabilization work and WRDA projects with a NFA to be capital assets warranting a CIP accounting treatment; and Congress has mandated that the Columbia and Snake River system Fish Mitigation Study Costs be accounted for in CIP. In April 2003, USACE implemented aggressive action to correct the Finding A noted CIP deficiencies. Data mining with specially developed SQL queries began in April and was immediately followed by a CIP information paper to include a monthly upward reporting process. The Internal Review auditors have monitored and assisted the Program Managers and Accountants as they cleanse the district CIP accounts. All USACE corrective actions were scheduled to be completed by 30 September 2003. In addition, the Corps has agreed to make statement level auditor recommended adjustments to our FY 03 financial statements for NFA cost share projects and the fish mitigation studies pending resolution.

d. **DoDIG Recommendation A-2**. We recommend that the Commander, U.S. Army Corps of Engineers reissue existing Corps Of Engineers policy for Construction-in-Progress financial reporting to:

(1) Clarify that the following expense-type events not resulting in the creation of capital asset should be expensed in the period incurred: reimbursements to local sponsors for completed work, fish, mitigation, programs, and bank stabilization work (including revetment mats).

(2) Require the transfer of completed projects or separable asset elements from the Construction-in-progress account in a manner consistent with the DoD Financial Management Regulation.

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e. **USACE Command Response.** We concur and the corrective action guidance already issued subordinate commands in response to Recommendation A-1 will be used to update the USACE Engineer Regulation 37-2-10 policy. In the interim, we have put out guidance in the form of information papers. This action should be completed by 30 June 2004.

f. **DoDIG Recommendation A-3.** We recommend that the Commander, U.S. Army Corps of Engineers modify the Corps of Engineers Financial Management System to allow for a distinct audit trail identifying Construction-Progress values to all originating source data.

g. **USACE Command Response.** We concur and the USACE CEFMS Development Team has already developed the requested report.

h. **DoDIG Recommendation A-4.** We recommend that the Commander, U.S Army Corps of Engineers issue policy requiring U.S. Army Corps of Engineers activities to retain originating source data to support Construction-in-Progress values maintained in the Corps of Engineers Financial Management System.

i. **USACE Command Response.** We concur and the CIP corrective action information paper already issued includes this requirement. In addition, action will be taken to have our Headquarters Corporate Information Records Management Office also issue updated guidance regarding the need for long-term retention of capital assets related valuation documents. This action will be completed by 30 June 2004.

3. Finding B - Financial Reporting of Non-Federal Cost Share Projects

a. **DoDIG Recommendation.** We recommend the Commander; U.S. Army Corps of Engineers expense all costs for constructing assets that will be transferred to a non-Federal sponsor upon completion.

b. **USACE Additional Facts.** The current FASAB promulgations technically do not address the CIP treatment of WRDA cost shared projects with a NFA. These projects currently represent about $3.6B of the $7.7B USACE CIP. In the Federal Government, only the Department of Interior Bureau of Reclamation performs similar WRDA related NFA work and we believe that both agencies perform similar CIP accounting. In addition, in the late 1990's USACE, the U.S. Army Audit Agency and the General Accounting Office informally discussed the USACE WRDA CIP accounting and no changes were recommended. A WRDA project is authorized by Congress and

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constructed by USACE using Federal funds and NFA sponsor contributions (e.g. land, easements, rights of way, like kind exchanges of assets, and funds). There is no doubt that USACE retains title to project construction features at least until operation and/or maintenance duties are turned over to the NFA. Even then, there is a continuing Federal interest in a congressional authorized Federal project. In many cases the project is an integral part of a Federal master plan for flood control or navigation. USACE project inspections are periodically performed to: ensure its structural integrity, confirm the projects meets its intended purpose, and validate that the NFA is performing its operation and maintenance responsibilities in accordance with the executed project cooperation agreement (PCA).

c. **USACE Command Response**. We partially concur for presentation of the FY 03 Civil Works consolidated financial statements. USACE agreed to perform a FY 03 statement level adjustment in October 2003 to the CIP account removing all NFA cost share costs in an amount quantified by the DoDIG. However, USACE believes an independent review is necessary to resolve this action for FY 04 and a review by a major independent Certified Public Accounting firm has begun with a 15 November 2003 reporting date. In addition, the DoD Comptroller with USACE participation will discuss this NFA CIP accounting issue with FASAB in the near future.

4. The POCs for this response are John Templeton (202-761-1985) or Mike Walsh (202-761-5440).

FOR THE COMMANDER:

JOHN E. TEMPLETON
Chief, Audit Executive
U.S. Army Corps of Engineers

Team Members

The Defense Financial Auditing Service Directorate, Office of the Deputy Inspector General for Auditing of the Department of Defense prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

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