

February 13, 2006



Financial Management

Accuracy of Navy Contract Financing Amounts (D-2006-050)

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Acronyms

CHOOSE	Cash History On-Line Operating Search Engine
DFAS	Defense Finance and Accounting Service
ERP	Enterprise Reporting System
GAO	Government Accountability Office
MOCAS	Mechanization of Contract Administration Service
NAVAIR	Naval Air Systems Command
OMB	Office of Management and Budget
SABRS	Standard Accounting, Budgeting, and Reporting System
STARS	Standard Accounting and Reporting System
STARS FL	Standard Accounting and Reporting System Field Level
STARS HCM	Standard Accounting and Reporting System Headquarter Claimant Module



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February 13, 2006

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
COMMANDER, NAVAL AIR SYSTEMS COMMAND
NAVAL INSPECTOR GENERAL
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE CLEVELAND CENTER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE KANSAS CITY CENTER

SUBJECT: Report on Accuracy of Navy Contract Financing Amounts (Report
No. D-2006-050)

We are providing this report for review and comment. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Defense Finance and Accounting Service comments were partially responsive. We request that the Defense Finance and Accounting Service provide additional comments on Recommendations B.1.a., B.1.b, C.2.a., and C.2.b. by March 13, 2006.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to Audcolu@dodig.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).

We appreciate the courtesies extended to the staff. Questions should be directed to James L. Kornides at (614) 751-1400 ext. 210 or Mr. Mark Starinsky at (614) 751-1400 ext 231. See Appendix B for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink, reading "Paul J. Granetto", is positioned above the typed name.

Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

Department of Defense Office of Inspector General

Report No. D-2006-050

February 13, 2006

(Project No. D2005-D000FJ-0038.000)

Accuracy of Navy Contract Financing Amounts

Executive Summary

Who Should Read This Report and Why? Civilian and military personnel responsible for collecting, summarizing, and reporting contract financing payments on the Navy financial statements should read this report. This report discusses the completeness and accuracy of the balance reported as contract financing by the Navy.

Background. Contract financing payments are authorized Government disbursements of monies to a contractor prior to the delivery of supplies or services by the Government. The Navy reported \$4.7 billion as an Outstanding Contract Financing balance in FY 2004. The balance is a part of the amount reported in the FY 2004 Balance Sheet as "Other Assets." We did not examine all of the data included in the FY 2004 Outstanding Contract Financing balance, but we did review the detailed transactions from the first 6 months of FY 2004 to evaluate the Navy process for deriving the balance. The Navy reported \$6.7 billion of contract financing payments for the first 6 months of FY 2004. This amount included \$5.1 billion maintained by Naval Air Systems Command (NAVAIR) and \$1.6 billion maintained by the Defense Finance and Accounting Service (DFAS). The NAVAIR data are maintained at Patuxent River, Maryland, and the DFAS data are maintained at Cleveland and Kansas City Centers.

Results. The amounts NAVAIR and DFAS reported as Outstanding Contract Financing Payments for the first 6 months of FY 2004 were not fully supported and did not accurately reflect all contract financing payments that the Navy paid.

During the audit, NAVAIR made improvements to correct weaknesses in its FY 2004 process during the audit. However, additional actions were still needed in FY 2005. The current process still lacked adequate written procedures, lacked adequate supporting evidence for \$466.2 million (absolute) of financing transactions, and excluded valid financing payment transactions totaling \$66.6 million (absolute) from the amount it reported. As a result, the \$4.7 billion Outstanding Contract Financing balance related to the FY 2004 transactions was not fully supported or complete. The weakness in reporting the appropriate amounts was material to the amount of NAVAIR financing payments on the balance sheet. Unless NAVAIR corrects its process for reporting contract financing, future Navy contract financing balances derived from the data will continue to be inaccurate. (See Finding A for the detailed recommendations.)

DFAS could not provide all supporting documentation for the financing balance it reported, excluded \$198 million from the beginning balance for FY 2004, and excluded at least \$238 million (absolute) of transactions related to the March 2004 ending balance. The amount DFAS reported did not include certain categories of appropriations, including those for the Marine Corps, and did not reflect other miscellaneous transactions. Additionally, DFAS could not provide support for \$64.5 million in "other transactions." As a result, the Navy reported an Outstanding Contract Financing balance

that was misstated by at least \$3.2 billion for the second quarter of FY 2004. These weaknesses were not corrected in FY 2005. Unless DFAS improves its controls for the reporting of contract financing transactions, the Navy will continue to report an inaccurate and unverifiable Outstanding Contract Financing balance on the financial statements. Therefore, the Navy Outstanding Contract Financing balance will not be auditable. (See Finding B for the detailed recommendations.)

The Navy and DFAS Management Control Programs for the Outstanding Contract Financing balance were ineffective and did not provide reasonable assurance that internal controls for the Outstanding Contract Financing balance were in place and operating effectively. As a result, the Navy and DFAS did not adequately identify and report material weaknesses for the Outstanding Contract Financing balance in the FY 2004 Annual Statement of Assurance. (See Finding C for the detailed recommendations.)

Management Comments and Audit Response. The Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) and the Director, Accounting Service for DFAS provided comments that were responsive. However, the Director, Accounting Service did not agree that DFAS Cleveland should maintain detailed support for the contract financing balance and stated that the control weaknesses are not material. He disagreed that any additional testing or reporting on the weaknesses is needed. We believe that DFAS Cleveland should maintain detailed records that support the account balance as required by Federal Accounting Standards and should report the material weaknesses. We request that the Director, Accounting Service for DFAS Cleveland reconsider his position and provide additional comments on these issues by March 13, 2006. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

Contract financing payments are defined by the Federal Acquisition Regulation as Government payments to a contractor prior to the delivery of supplies or services by the Government. The Navy reports its contract financing as an Outstanding Contract Financing balance, and that amount is included in the Other Assets account on the Balance Sheet of the Navy financial statements.

The Outstanding Contract Financing balance includes several types of transactions. The first type of transaction is contract financing payments. Another type of transaction that affects the Outstanding Contract Financing balance occurs when the final product or service is delivered. Upon delivery, the Navy records a negative adjustment (recoupment) to remove the associated contract financing amounts, which results in a reduction of the total contract financing balance. Other transactions, such as adjustments that the Navy or Defense Finance and Accounting Service (DFAS) record as a result of research related to the original contract financing payments, also affect the outstanding balance.

Federal Acquisition Regulation (FAR) 32.503-5, “Administration of Progress Payments,” requires that contract financing be supported by the fair value of the work accomplished by the contractor. In its financial statements, the Navy reported three types of contract financing payments: performance-based payments, progress-based payments, and commercial financing interim payments.

Performance-based payments. According to the FAR, performance-based payments are contract financing payments made on the basis of performance measured by objective, quantifiable methods; accomplishment of defined events; or other quantifiable measures of results.

Progress-based payments. Progress-based payments are contract financing payments made on the basis of the contractor cost or percentage of completion accomplished. Defense Federal Acquisition Regulation Supplement 232.501-1, “Customary Progress Payment Rates,” designates a customary DoD progress payment rate of 80 percent of a contractor’s cumulative allowable costs. Contractors provide cost data through progress payment requests that summarize the total allowable costs incurred on a contract as of a specified date. The FAR states that progress payments may include reasonable and applicable costs consistent with generally accepted accounting principles and payments that have been made to subcontractors or suppliers, or both by some form of payment. Progress payments may not include incurred costs by subcontractors or suppliers, or costs that would otherwise be capitalized. As goods and services are provided, progress payments are liquidated, or recouped, based on the progress payment rate established in the contract.

Commercial financing interim payments. Commercial financing interim payments are contract financing payments made under specific circumstances. Either the contract item financed is a commercial supply or service or the contract price exceeds the simplified acquisition threshold and the contracting officer determines that it is appropriate or customary in the commercial marketplace to make financing payments for the item.

Systems for Reporting Contract Financing. The Navy uses four systems to account for contract financing. Specifically, NAVAIR uses Enterprise Reporting System (ERP). DFAS Cleveland uses the Standard Accounting and Reporting System (STARS), STARS Headquarter Claimant Module (STARS HCM), and STARS Field Level (STARS FL). DFAS Kansas City uses the Standard Accounting, Budgeting, and Reporting System (SABRS).

DFAS Columbus utilizes the Mechanization of Contract Administration Service (MOCAS) system as the administration and disbursement system for contractor payments including financing payments. DFAS Columbus submits payment information directly to STARS HCM and Defense Cash Accountability System before going to the Central Master Edit Table or Air Master Edit Table. These tables are designed to separate the data to be processed either through ERP or STARS FL. After ERP, STARS FL, and SABRS process the contract financing transactions, the data are sent to DFAS Cleveland to be posted to the Financial Statements.

Amount of Contract Financing in FY 2004. For those contract financing payments reported as Outstanding Contract Financing, the Defense Contract Management Agency was primarily responsible for administering and approving contract financing payments on DoD contracts, and DFAS Columbus was responsible for payment. In the first 6 months of FY 2004, the DFAS Columbus Center disbursed about \$11.4 billion in U.S. progress payments, performance-based payments, and commercial financing interim payments to Defense contractors. The Navy reported \$4.7 billion in these three types of contract financing payments on the financial statements for FY 2004.

For second quarter of FY 2004, the Navy reported a \$6.7 billion balance for outstanding contract financing transactions. Of the \$6.7 billion, the Navy included \$5.1 billion from NAVAIR and \$1.6 billion from DFAS Cleveland.

Objectives

The audit objective was to determine whether the Navy is accurately collecting and reporting on its financial statement all contract financing payments that were paid by DFAS Columbus during FY 2004. We also reviewed the management control program as it related to the overall objective. See Appendix A for a discussion of the scope and methodology.

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 the management controls of the Navy and DFAS Cleveland over the reporting of contract financing payments on the Balance Sheet. Specifically, we determined whether the Navy and DFAS Cleveland accurately reported Outstanding Contract Financing balances. We also reviewed the adequacy of management's self-evaluation of those controls.

Adequacy of Management Controls. We identified material management control weaknesses for the Navy and DFAS Cleveland, as defined by DoD Instruction 5010.40. The Navy and DFAS Cleveland management controls for accurately reporting Outstanding Contract Financing balances were not adequate to ensure that the Outstanding Contract Financing balance was complete and supportable. The recommendations in this report, if implemented, will correct the identified weaknesses. A copy of the report will be provided to the senior officials responsible for management controls in the Navy and DFAS Cleveland.

Adequacy of Management's Self-Evaluation. The Navy and DFAS officials did not identify the reporting of the Outstanding Contract Financing balance as an assessable unit and, therefore, did not identify or report the material management control weaknesses identified by the audit.

A. Naval Air Systems Command Process for Reporting Contract Financing Amounts

The \$5.1 billion included by NAVAIR as its portion of the contract financing balance on the Navy's second quarter FY 2004 financial statement was not fully supported and did not reflect all amounts of contract financing transactions associated with NAVAIR. This occurred because NAVAIR did not establish a process to accurately report contract financing transactions in FY 2004. While NAVAIR made adjustments to the process during the audit to correct these weaknesses, the current process still had weaknesses. The 2004 NAVAIR process included:

- an unsupportable beginning balance of \$3.8 billion,
- an apparent duplicate posting of \$8.2 billion (absolute) of transactions that occurred in the 4th quarter of FY 2003, and
- the exclusion of \$2.5 billion (absolute) of valid contract financing transactions that occurred in the first quarter of FY 2004.

The 2005 NAVAIR process included:

- a lack of adequate written procedures,
- a lack of adequate supporting evidence for \$458.2 million (absolute), and
- the exclusion of valid transactions totaling \$66.5 million (absolute) that were not posted to the accounting system.

Although NAVAIR improved its reporting procedures for FY 2005, a lack of controls over the contract financing transactions that comprise the balance remained. As a result, the Navy could not demonstrate its contract financing balance for FY 2004 was correct and will not be able to assert that the FY 2005 and future balances will be accurate until improvements are made.

NAVAIR 2004 Process for Reporting Contract Financing

In FY 2003 and FY 2004, NAVAIR reported its quarterly and year-end outstanding contract financing balance by adding the prior period ending balance to the contract financing transactions for the most recent quarter. NAVAIR uses the ERP system as their accounting system.

FY 2004 Beginning Balance. NAVAIR reported a beginning FY 2004 contract financing balance of \$3.8 billion but could not provide supporting documentation for the entire amount. The \$3.8 billion reported for the first quarter of FY 2004 was \$850 million less than the ending FY 2003 balance (an 18 percent decrease).

NAVAIR was unable to explain why the first quarter FY 2004 balance did not match the FY 2003 ending balance and could not provide any details to support the FY 2004 beginning balance. The beginning balance lacked a detailed audit trail that would support the \$3.8 billion balance. The second quarter FY 2004 beginning balance matched the first quarter ending balance. Table 1 shows the beginning and ending balances for FY 2004 first and second quarters.

Table 1. Analysis of Beginning and Ending Balances.				
Financial Statement Reporting Period	Ending Balance	Beginning Balance	Difference	Percent Difference
FY 2003 4th quarter	\$4,603,969,318			
FY 2004 1st quarter		\$3,758,791,213	\$(845,178,105)	(18.36)%
FY 2004 1st quarter	\$4,958,715,637			
FY 2004 2nd quarter		\$4,958,715,645	\$7	0.00%

NAVAIR was unable to provide support for the change in the FY 2004 beginning balance. Our analysis of the data that were available showed that the change in dollar value from the ending FY 2003 balance to the beginning FY 2004 balance occurred because a control to ensure that the ending balance reconciled to the beginning balance was not in place. NAVAIR did not have the necessary internal controls in place to ensure that the correct contract financing balance had been used and that change in balances were properly supported. Specifically, NAVAIR should have maintained records that supported the change in balance from FY 2003 to FY 2004.

Potential Duplicate Postings. The NAVAIR data indicated that in FY 2004 NAVAIR erroneously posted \$8.2 billion (absolute) of contract financing transactions that occurred in FY 2003. In the first quarter of FY 2004, instead of posting first quarter FY 2004 detailed transactions to obtain the first quarter FY 2004 balance, NAVAIR posted detailed transactions that occurred in the fourth quarter of FY 2003. Because NAVAIR was unable to provide support for the FY 2004 beginning balance, we could not determine whether NAVAIR had also previously posted these transactions in FY 2003. These transactions potentially may have been included in the ending contract financing balance twice. The \$8.2 billion (absolute) of unsupportable transactions had a net value of \$1.2 billion.

The improper posting of FY 2003 transactions in FY 2004 occurred because NAVAIR did not have internal controls in place to ensure that contract financing transactions were posted in the proper accounting period and only one time. A process to reconcile posted transactions to the MOCAS records would have identified this weakness.

Exclusion of Valid First Quarter FY 2004 Transactions. NAVAIR excluded at least \$2.5 billion (absolute) of valid first quarter FY 2004 contract financing transactions from the Navy balance sheet for the first and second quarter of FY 2004. Specifically, we identified at least 2,760 MOCAS contract financing transactions associated with NAVAIR that occurred in the first quarter FY 2004 totaling \$0.4 billion (net) and \$2.5 billion (absolute) that were excluded.

NAVAIR did not post any first quarter FY 2004 contract financing transactions because NAVAIR did not have controls in place to ensure that all contract financing transactions were posted in the proper accounting period. Specifically, a process to reconcile posted transactions to the MOCAS records would have identified this weakness.

Changes to NAVAIR Reporting Process for 2005

The NAVAIR process of reporting its contract financing balance on the balance sheet for FY 2004 resulted in at least \$14 billion (absolute) of unsupported or inaccurate contract financing transactions. During the audit and based on inquiries from the Office of the Assistant Secretary of the Navy (Financial Management and Comptroller), NAVAIR realized that the process for reporting contract financing was inadequate and instituted changes to its accounting process for contract financing. Because of the changes that occurred for FY 2005, we are not making any recommendations associated with the weaknesses that we observed for FY 2004. Instead, we have reviewed the FY 2005 process.

NAVAIR Process for Reporting Contract Financing

FY 2005. During the first quarter of FY 2005, NAVAIR changed its process for reporting its contract financing balance. The FY 2005 NAVAIR process extracts all contract financing transactions that have been posted in ERP and also adds summary contract financing amounts associated with FY 2002 and prior years. NAVAIR sends this amount to DFAS Cleveland to be reported on the financial statements. To determine if NAVAIR had implemented improvements to the reporting process, we reviewed transactions during the same period (October 1, 2003 through March 31, 2004).

The NAVAIR process had improved. Specifically, NAVAIR was able to provide detailed support for the entire contract financing balance. About 90 percent of the absolute value of the first half of FY 2004 ERP transactions were reconcilable to MOCAS records for the same time period. However, the records showed that inaccuracies and control weaknesses, including continued lack of an adequate audit trail, remained.

Adequacy of Written Procedures. NAVAIR did not develop or maintain written procedures for the new process for reporting contract financing. Written procedures are vital to ensure that the intent of management is carried out and to ensure the accuracy and consistency of reported balances. Written procedures help prevent errors and unintended consequences from occurring, such as when employee turnover occurs. NAVAIR should develop written procedures to document the process to extract the contract financing transactions reported on the balance sheet and to save the transactions with enough detail to allow for an audit trail.

Accuracy of the NAVAIR Balance. For transactions that occurred during the first half of FY 2004, we were able to reconcile 7,477 out of 7,744 ERP transactions to supporting MOCAS records. The reconciled transactions totaled

92 percent of the absolute value of the NAVAIR reported amounts. The remaining 267 transactions valued at \$431.0 million (absolute) were not supported by MOCAS records. Additionally, we identified 99 FY 2003 invoices valued at \$27.1 million (absolute) that were not supported by MOCAS records and 94 valid MOCAS transactions valued at negative \$50.8 million (net) and \$66.5 million (absolute) that were not included in the NAVAIR balance but should have been.

Supportability of NAVAIR Transactions. For the FY 2004 transactions we examined, 267 totaling negative \$19.9 million (net) and \$431.1 million (absolute) were not supported by MOCAS transactions posted in the same accounting period. We also identified 99 FY 2003 transactions valued at negative \$13.5 million (net) and \$27.1 million (absolute) that were not supported by MOCAS transactions posted in the same accounting period. These unreconcilable transactions appeared to be either NAVAIR duplicates of valid transactions or were reversals of valid transactions. There were 15 other miscellaneous postings that NAVAIR could not explain. Table 2 contains a summary of the unsupported NAVAIR transactions.

Table 2. Unsupported NAVAIR FY 2004 Transactions			
		(in millions)	
	Number of <u>Invoices</u>	<u>Net value</u>	<u>Absolute Value</u>
Duplicate Postings	33	\$ 2.4	\$ 2.4
Reconciliation	183	(24.6)	45.1
Reversing Entries	135	(9.3)	408.0
Miscellaneous	<u>15</u>	<u>(1.9)</u>	<u>2.7</u>
Total	366	\$(33.4)	\$458.2

Duplicate Postings. ERP records showed that NAVAIR made 33 duplicate postings related to transactions with a treasury date of November 11, 2003. The duplicate posting of the 33 transactions resulted in a \$2.4 million (net) and \$2.4 million (absolute) overstatement of the outstanding contract financing balance for first and second quarter of FY 2004. NAVAIR was unable to provide an explanation as to why these transactions were posted in the ERP database.

Reconciliation. NAVAIR personnel stated that when ERP first came on-line, some payments were excluded because NAVAIR believed them to be duplicate payments. However, in the beginning of 2004, NAVAIR realized that the excluded payments were not duplicates and should have been recorded in the database. To correct the problem, NAVAIR performed a reconciliation of the transactions in ERP to MOCAS files to identify the valid payments that had been excluded and to record them in the database. NAVAIR posted the excluded payments on March 4, 2004. We included the payments in our audit because the posting date fell within our scope even though the payments occurred in FY 2003.

To determine whether the FY 2003 transactions were valid, we analyzed MOCAS contract records to quantify the number of payments made, the payment amount, and other relevant accounting data. We compared the MOCAS data to the entire ERP database (including transactions posted in FY 2003). NAVAIR posted at least 183 transactions totaling negative \$24.6 million (net) and \$45.1 million

(absolute) related to the March 4, 2004, transactions that did not reconcile to MOCAS.

Reversing Entries. NAVAIR posted 135 contract financing transactions in the ERP database on January 21, 2004, that were not supported by MOCAS transactions for the same time period. These transactions were related to a specific contract and reversed 135 transactions posted to ERP on May 23, 2003. The 135 transactions originally posted on May 23, 2003, were supported by MOCAS records. The accounting adjustment resulted in a negative \$9.3 million (net) and \$408 million (absolute) of incorrect transactions posted to ERP in second quarter FY 2004.

Other Miscellaneous Transactions. NAVAIR posted 15 additional transactions totaling negative \$1.9 million (net) and \$2.7 million (absolute) that were not supported by MOCAS records. NAVAIR could not explain why these transactions were included in the contract financing database.

Exclusion of Valid Transactions. When calculating its contracting financing balance, NAVAIR excluded 18 valid transactions related to certain accounting stations, overlooked 58 transactions during a reconciliation of ERP and MOCAS, and also excluded 18 other miscellaneous transactions. See Table 3 for a summary of the excluded valid MOCAS transactions.

Table 3. Excluded Valid MOCAS Transactions			
		(in millions)	
	Number of <u>Invoices</u>	<u>Net value</u>	<u>Absolute Value</u>
Excluded Accounting Stations	18	\$ (0.7)	\$ 1.0
Overlooked Transactions	58	(49.8)	63.7
Miscellaneous	<u>18</u>	<u>(0.3)</u>	<u>1.8</u>
Total	94	\$(50.8)	\$66.5

Excluded Accounting Stations. When calculating its first and second quarter contract financing balance, NAVAIR did not include contract financing transactions from two accounting stations. These stations are responsible for reporting accounting information for two NAVAIR inventory control points. Because of the NAVAIR oversight, 18 transactions from October 1, 2003, through March 31, 2004, totaling negative \$0.7 million (net) and \$1.0 million (absolute) were excluded from the NAVAIR contract financing balance.

Overlooked Transactions. NAVAIR did not report at least 58 contract financing transactions totaling negative \$49.8 million (net) and \$63.7 million (absolute) because its reconciliation to MOCAS transactions did not identify them as missing from the ERP database. NAVAIR was unable to explain why those transactions were excluded from the ERP database.

Miscellaneous Excluded Transactions. NAVAIR excluded 18 transactions totaling negative \$0.3 million (net) and \$1.8 million (absolute) from the reported contract financing amount. We provided these transactions to NAVAIR, but they were unable to explain why these transactions were not in their database.

Effect on Navy Financial Statements

The weaknesses that we found could be material to the balance sheet amount. The Navy did not maintain written procedures for compiling its contract financing balance, excluded valid contract financing amounts, and included contract financing amounts that were not supported by source documentation in MOCAS. Future Navy contract financing balances derived from ERP data will continue to be inaccurate until improvements are made.

Recommendations and Management Comments

A.1. We recommend that the Commander Naval Air Systems Command:

a. Direct the establishment of written procedures for preparing the contract financing balance, including the retention of a proper audit trail.

Management Comments. The Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) concurred with the recommendation and stated that the Navy will use data from U.S. Treasury Department to better reflect contract financing payments. He stated that the Navy has developed written procedures and instituted a process to validate the ending balance with the beginning balance. He indicated that Naval Air Systems Command has strengthened the basic information technology controls around the cash file receipt, subsequent file management, and internal posting of transactions received from DFAS.

b. Direct the establishment of procedures for including all supportable, valid contract financing transactions into the Enterprise Resource Planning database, such as performing a reconciliation of Enterprise Resource Planning transactions to Mechanization of Contract Administration Service transactions.

Management Comments. The Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) concurred with the recommendation and stated that the Navy determined that some accounts were not included in the appropriate area and has taken corrective action to have them included. DFAS Cleveland and Navy Air System Command have an ongoing effort to reexamine this process and plan to perform an end-to-end review of the disbursements process.

B. Defense Finance and Accounting Service Process for Reporting Navy Contract Financing

The \$1.6 billion submitted by DFAS as its input for the contract financing balance on the Navy's second quarter 2004 financial statements did not reflect all amounts of contract financing transactions associated with the Navy. This occurred because the DFAS process for reporting the Navy contract financing balance maintained in STARS and SABRS did not provide complete and accurate accounting information. Specifically, DFAS

- could not provide accurate supporting documentation for the change it made to the contract financing balance from FY 2003 through the second quarter of FY 2004;
- inappropriately excluded transactions associated with FY 2003 appropriations when calculating the beginning balance for FY 2004;
- inappropriately excluded all contract financing transactions that occurred in March 2004, certain STARS subheads, and other miscellaneous contract financing transactions;
- inconsistently reported or inappropriately excluded contract financing transactions related to the Marine Corps and;
- inappropriately included transactions that were not supportable.

These weaknesses occurred because DFAS does not have adequate controls to prepare an accurate and supportable contract financing balance. As a result, the Navy reported contract financing balance was misstated by at least \$3.2 billion (absolute.) If internal controls for the reporting of contract financing transactions are not improved, the Navy will continue to report an inaccurate and unverifiable contract financing balance on the financial statements.

Process for Reporting STARS Contract Financing Amounts

DFAS Cleveland personnel performed a query of STARS information on a quarterly basis to obtain the ending balance for several financial statement line items, including contract financing (General Ledger account 1450.300). STARS provides the information at a summary level by appropriation, year, and subhead. A subhead is a further subdivision of an appropriation that indicates accounting information for transactions associated with that particular appropriation, such as STARS, ERP, or SABRS. To report the quarterly contract financing balance, DFAS Cleveland personnel removed all balances related to canceled appropriations and posted the remaining amount into a trial balance, which was imported into their general ledger system. STARS contract financing data

accounted for \$1.6 billion of the \$6.7 billion of the total Navy contract financing balance for the second quarter of FY 2004.

Adequacy of DFAS Process for Reporting STARS and SABRS Amounts

The data provided by DFAS Cleveland did not support the reported change in the STARS balance from FY 2003 through the end of the second quarter of FY 2004. The DFAS supporting data excluded certain contract financing transactions that occurred and also included unsupported transactions.

Supportable Audit Trail. DFAS Cleveland was unable to provide detailed support for the change in the reported contract financing balance from \$1.2 billion at the end of FY 2003 to \$1.6 billion through the second quarter of FY 2004. We requested all transactions that accounted for the change in the contract financing balance during this period, but DFAS Cleveland had not retained that documentation. DFAS Cleveland did provide detailed STARS contract financing transactions related to the outstanding contract financing balance that were posted during that timeframe. However, the detailed STARS data did not match the summary change. The summary change was \$412 million (net) more than the detailed transactions. Part of the \$412 million difference related to DFAS Cleveland excluding detailed transactions associated with FY 2003 appropriations and excluding March 2004 transactions from the March 2004 summary data.

In addition, DFAS Cleveland was unable to provide written procedures for compiling and reporting the outstanding contract financing amount. Written procedures are important to ensure consistency and accountability and to demonstrate management oversight of the process. From October 2004 through March 2005, at least three different individuals compiled this balance. Written procedures would have improved the employees' understanding of their job requirements. If written procedures for preparing contract financing balances had been available during this period, more documentation may have been available to support reported contract financing balances.

Completeness of Reported Contract Financing Balance. Although DFAS Cleveland was not able to provide an adequate audit trail, DFAS Cleveland did provide sufficient documentation so that we were able to perform limited analysis of the summary and detailed data. We were able to reconcile negative \$4.5 million (net), which is 103 percent, and \$1,114.4 million (absolute), which is 95 percent, of the negative \$3.6 million (net) in posted transactions in the first two quarters of FY 2004 that were supported by MOCAS transactions. However, we identified instances in which DFAS Cleveland excluded valid transactions. The DFAS exclusions totaled about \$3.2 billion (absolute), which was material to the March 31, 2004, reported ending balance.

Table 4 shows a summary of the excluded transactions that affected the FY 2004 second quarter Outstanding Contract Financing balance.

Table 4. Excluded Valid MOCAS Transactions (in millions)		
	<u>Net Value</u>	<u>Absolute Value</u>
March 2004	\$ 38.7	\$ 237.8
STARS Subheads	42.7	119.3
Miscellaneous	(26.3)	68.4
Marine Corps	197.7	2,724.8
Total	\$252.8	\$3,150.3

Reporting FY 2003 Appropriations. DFAS Cleveland excluded all balances related to FY 2003 appropriations in the ending FY 2003 balance (which is the beginning FY 2004 balance). Based on DFAS data for the Navy, the FY 2004 beginning balances for the FY 2003 appropriation with STARS subheads would have totaled \$198 million. This material amount is 16 percent of the FY 2003 reported ending balance of \$1,202.8 million. DFAS Cleveland was unable to explain why these appropriations were not included on the FY 2003 balance. When DFAS Cleveland prepared the March 31, 2004, Outstanding Contract Financing balance, it correctly included these appropriations. However, further controls, such as a reconciliation of posted transactions to MOCAS records, are needed to ensure that all valid appropriations are always included.

Reporting March 2004 Contract Financing Transactions. When DFAS Cleveland prepared the March 31, 2004, Outstanding Contract Financing balance, it excluded all negative \$38.7 million (net) and \$237.8 million (absolute) contract financing transactions that occurred in March 2004. DFAS Cleveland personnel were unable to explain why the March transactions were not included in the March 31, 2004, Outstanding Contract Financing balance. Additionally, data were not available for us to determine with absolute certainty that the March 2004 contract financing transactions were included in the ending FY 2004 balance. Further controls, such as a reconciliation of posted transactions to MOCAS records, are needed to ensure that all transactions for the reporting period are included in the financial statements.

Including All Appropriate STARS Subheads. The STARS data showed that DFAS Cleveland excluded 38 subheads that should have been included in the STARS contract financing transactions. For the first two quarters of FY 2004, we identified 216 MOCAS transactions totaling \$50 million (absolute) and \$41 million (net) related to the 38 subheads. The Cash History On-Line Operating Search Engine (CHOOSE), the Navy system that registers transactions reported to Treasury, showed that the contract financing transactions for these subheads as of March 31, 2004, totaled \$42.7 million (net) and \$119.3 million (absolute). DFAS Cleveland could not explain why these subheads were not reported on the financial statements. Additional controls, such as a reconciliation of posted transactions to MOCAS records, are needed to ensure that all Navy contract financing transactions are included on the balance sheet.

Including Other Valid Contract Financing Transactions. DFAS Cleveland did not include 178 MOCAS contract financing transactions that occurred between October 1, 2003, and March 31, 2004, in the financial statements. The 178 transactions totaled negative \$26.3 million (net) and \$68.4 million (absolute). We determined that the 178 transactions were associated with accounting subheads that DFAS had otherwise included in the Navy financial statements. DFAS Cleveland could not explain why these transactions were not in the financial statements. Additional controls are needed to ensure that all Navy contract financing transactions are included on the balance sheet. Specifically, the Navy needed to reconcile STARS posted transactions to MOCAS records.

Including Marine Corps Contract Financing Transactions. DFAS is not consistently and accurately reporting \$197 million (net) and \$2,720.9 million (absolute) of contract financing amounts related to the Marine Corps. Specifically, DFAS reports a portion of the Marine Corps contract financing as Advances and Prepayments and excludes the remaining portion from the balance sheet.

DFAS Kansas City provides finance and accounting and reporting services for the Marine Corps. According to the DFAS Kansas City audited financial statement branch, information contained in the Marine Corps SABRS system is incorporated into the Navy financial statements. According to DFAS Kansas City, MOCAS transactions coded with “6W” are included in the prepayments General Ledger Account Classification. DFAS Kansas City stated that for the second quarter FY 2004, they reported \$159.0 million in prepayments for the Marine Corps. However, a large portion of the reported prepayments were related to 6W transactions in MOCAS. DFAS misclassified the contract financing payments coded as 6W as advances and prepayments. DFAS should report these transactions as Navy contract financing transactions. Navy CHOOSE, as of March 31, 2005, showed total contract financing transactions (open appropriations coded with 6W) of about \$174.6 million (net) and \$2,572.2 million (absolute). For the six month period, MOCAS records showed 851 transactions totaling negative \$66 million (net) and \$343.5 million (absolute) related to the Marine Corps appropriations.

In addition, neither DFAS Kansas City nor DFAS Cleveland included other appropriation and subhead combinations related to the Marine Corps Research, Design, Test and Evaluation and Navy Procurement appropriations on the balance sheet as Outstanding Contract Financing Payments or Advances and Prepayments. These additional appropriations and subheads combinations should have been included in the Marine Corps Outstanding Contract Financing balance. MOCAS records showed 68 transactions valued at \$4.5 million (net) and \$42.0 million (absolute) related to these subheads that were overlooked. Navy disbursement records also showed total contract financing transactions for these subheads of about \$23 million (net) and \$152.5 million (absolute.) DFAS did not have any procedure in place to ensure that these amounts were reported on the Navy financial statements. A process to reconcile posted transactions to the MOCAS records would have identified this weakness. In addition, a DFAS policy directing all Marine Corps subhead balances be reported would have helped identify the weakness.

Verifying the Source of Other Transactions. DFAS Cleveland included 192 transactions in the STARS contract financing balance that were not supported by MOCAS transactions. The unreconcilable transactions totaled negative \$0.9 million (net) and \$64.5 million (absolute). DFAS Cleveland personnel were unable to explain how these transactions were included in the Outstanding Contract Financing balance. Additional controls are needed to ensure that all contract financing transactions reported on the balance sheet are supportable by detailed transactions. A process to reconcile posted transactions to the MOCAS records would have identified this weakness.

Effect on Navy Financial Statements.

The Navy reported an Outstanding Contract Financing balance from STARS and SABRS that was inconsistent, incomplete, and inaccurate. If internal controls for the reporting of contract financing transactions are not improved, the Navy will continue to report an inaccurate and unverifiable Outstanding Contract Financing balance on the financial statements.

The \$6.7 billion Outstanding Contract Financing balance on the Navy's second quarter 2004 financial statements did not reflect all amounts of STARS and SABRS contract financing transactions that it should have. In preparing the midyear contract financing balance for the Navy, DFAS excluded valid transactions totaling \$252.7 million (net) and \$3,150.3 million (absolute). Additional procedures are needed so that an accurate Outstanding Contract Financing balance is calculated in the future.

Recommendations, Management Comments, and Audit Response

B.1 We recommend that the Director of Defense Finance and Accounting Service Cleveland establish policies to:

a. Retain detailed documentation that supports reported Outstanding Contract Financing balances. A reconciliation of posted transactions to the Mechanization of Contract Administration Service records would have identified this weakness.

Management Comments. The Director, Accounting Services partially concurred. He stated that DFAS Cleveland is presently developing a reconciliation process between the U.S. Treasury Department records and the Navy Accounting System records. The reconciliation will ensure that transactions processed by MOCAS through Treasury are matched to those processed in the accounting system.

Audit Response. The Director's comments are partially responsive. While we agree that reconciling MOCAS, Treasury, and STARS data will help ensure that all transactions are recorded in STARS, DFAS needs to ensure that proper documentation is retained to support the contract financing balance. For example, the supporting documentation provided to us for the first two quarters of FY 2004

did not match the balance derived from the queries that were saved as support for the balance. DFAS was unable to explain the difference, and only our detailed analysis showed the origin of some of the discrepancies. Retention of the detailed documentation for the transactions could have shown the discrepancies sooner. We request that the Director reconsider his position on the recommendation and provide comments on the final report.

b. Ensure that all valid contract financing transactions are included in the Outstanding Contract Financing balances, including appropriations and subheads. A complete reconciliation of transactions posted to the financial statements and the Mechanization of Contract Administration Service transactions would have identified this weakness.

Management Comments. The Director, Accounting Services partially concurred with the recommendation. Specifically, DFAS stated that FY 2003 appropriations and March 2004 transactions were excluded because of staff inexperience and changes in personnel. DFAS stated that controls are in place to ensure that the current accounting month is included in the queries, that an experienced senior member performs the data extraction, and that DFAS is drafting a data extraction desktop operating procedure. DFAS Cleveland disagreed that they could not provide supporting documentation for the change it made to the contract financing balance from FY 2003 through the second quarter of FY 2004. DFAS Cleveland stated that they provided a data file containing MOCAS transactions based on required data elements.

Audit Response. The Director's comments were responsive. We agree that desk procedures related to data extraction will help ensure that all valid transactions are included in the contract financing balance. However, the detailed data provided by DFAS Cleveland did not match the summary change in the Navy contract financing balance. Therefore, additional controls need to be in place to ensure that all valid transactions are included. In addition, as discussed in the finding, DFAS Cleveland did not include all valid MOCAS transactions from FY 2003 through the second quarter of FY 2004. We request that Management reconsider their position and provide additional comments.

B.2 We recommend that the Director of Defense Finance and Accounting Service Kansas City establish a written policy to report contract financing transactions that is consistent with the Federal Accounting Standards for reporting contract financing transactions.

Management Comments. The Director, Accounting Services concurred with our recommendation. He stated that DFAS would revise written policy to ensure that the contract financing transactions are reported appropriately in the footnotes.

B.3 We recommend that the Director of Defense Finance and Accounting Service assign responsibility to the appropriate staff for reporting Marine Corps contract financing transactions related to Navy Procurement and Research, Design, Test, and Evaluation procurements and issue policy that those amounts be reported separately from advances and prepayments on the Balance Sheet.

Management Comments. The Director, Accounting Services concurred with the recommendation. He stated that DFAS will set up procedures to capture and report the Marine Corps subheads for these appropriations.

C. Navy and Defense Finance and Accounting Management Control Program

The Navy and DFAS Management Control Programs were ineffective for ensuring an accurate, supportable General Fund Outstanding Contract Financing Balance. Although the Navy disclosed a material weakness related to the accuracy of its financial statements, it did not specifically identify contract financing as an area of weakness. The responsible DFAS Centers did not identify and report a material weakness for the Navy Outstanding Contract Financing Balance in their FY 2004 Annual Statement of Assurance. These weaknesses occurred because the Navy and DFAS did not adequately perform a general assessment of the internal controls for the Outstanding Contract Financing balance. Specifically, the Navy and DFAS Management Control Programs did not establish clear control objectives, potential risks, and control techniques within their assessable units that would have prevented the material weaknesses from occurring. As a result, the Navy and DFAS cannot provide reasonable assurance that internal controls for the Outstanding Contract Financing balance are in place and operating effectively.

Criteria for Management Control Programs

Government Accountability Office (GAO). GAO/AIMD-00-21.3.1, “Standards for Internal Control in the Federal Government,” November 1999, (The Green Book) states:

The Federal Managers’ Financial Integrity Act (FMFIA) of 1982 requires GAO to issue standards for internal control in Government. The standards provide the overall framework for establishing and maintaining internal control and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement.

The five standards for internal control are: control environment, risk assessment, control activities, information and communications, and monitoring. These standards define the minimum level of quality acceptable for internal control in government and provide the basis against which internal control is to be evaluated.

Office of Management and Budget (OMB). OMB Circular A-123, “Management Accountability and Control,” revised Jun 21, 1995¹, provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on management controls. The OMB Circular states:

¹ The OMB recently issued a revised OMB Circular A-123, “Management’s Responsibility for Internal Control,” December 21, 2004; however, this revised guidance does not take effect until FY 2006. In the interim, the previous guidance should be followed.

Management controls are the organization, policies, and procedures used by agencies to reasonably ensure that programs achieve their intended results; resources are used consistent with agency mission; programs and resources are protected from waste, fraud, and mismanagement; laws and regulations are followed; and reliable and timely information is obtained, maintained, reported, and used for decision making.

DoD Directive. DoD Directive 5010.38, “Management Control (MC) Program,” August 26, 1996, implements GAO and OMB guidance that is required by the FMFIA of 1982. The DoD Directive requires DoD Components to implement a comprehensive strategy for management controls that provides reasonable assurance that “. . . programs and administrative and operating functions are efficiently and effectively carried out in accordance with applicable law and management policy.” The management control process should be integrated into the daily management practices of all DoD managers. When developing the Management Control Program, DoD managers should rely on all contributing information sources, including external audits.

DoD Instruction. DoD Instruction 5010.40, “Management Control Program (MC) Program Procedures” August 28, 1996, requires DoD Components to develop a Management Control Program. The Management Control Program, through its self assessment process, assists managers in identifying material management control weaknesses. The DoD instruction states that in order for the deficiency to be a material weakness, two conditions must be met:

- management controls are not in place, not used, or not adequate; and
- the weakness is material enough to require the attention of the next level of management.

Each DoD Component should submit an annual statement of assurance based on a general assessment of the effectiveness of the management controls.

Navy and DFAS General Assessment of Internal Controls

The Navy and DFAS did not adequately perform a general assessment of their internal controls for the Outstanding Contract Financing balance. Specifically, the Navy and DFAS Management Control Program did not establish specific control objectives, potential risks, and control techniques within their assessable units that would have prevented the material weaknesses from occurring. Further, the Navy and DFAS did not have a test of controls for reconciling the General Fund Outstanding Contract Financing balance to source documentation.

Navy. The Navy had an assessable unit for audited financial statements. The Navy reported a material weakness related to this assessable unit, but did not establish specific control objectives and control techniques to prevent the material weaknesses identified in Finding A from occurring. Further, the Navy did not have any test of controls for verifying the completeness and accuracy of the Outstanding Contract Financing balance. Specifically, Navy officials did not

attempt to reconcile transactions which comprised the Outstanding Contract Financing balance with the detailed support from the disbursing stations.

DFAS. DFAS Cleveland had an assessable unit for audited financial statements. However, DFAS Cleveland did not report material control weaknesses related to this assessable unit. The controls over this specific unit did not identify the potential risks and controls techniques to prevent the material weaknesses from occurring. Additionally, DFAS officials did not attempt to reconcile transactions which comprised the Outstanding Contract Financing balance with the detailed support from the disbursing activities.

DFAS Kansas City had an assessable unit for Accounting Procedures and Practices. The purpose of the assessable unit is to provide accounting guidance for DFAS Kansas City and supported activities. DFAS Kansas City did not report a material weakness for this assessable unit. The controls over this specific unit did not identify the potential risks and control techniques, such as providing accounting procedures that comply with Federal Accounting Standards, to prevent the material weakness from occurring.

Recommendations, Management Comments, and Auditor Response.

C.1. We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller):

a. Develop tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses identified in Finding A of this report, and

Management Comments. The Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller) concurred with the recommendation. That office will work with Naval Air System Command to ensure development of tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses identified by the audit.

b. Report the material weaknesses identified in Finding A of this report in the Navy Annual Statement of Assurance.

Management Comments. The Director, Office of Financial Operations concurred with the recommendation and stated that the issue of contract financing will be reviewed to determine if it should be included in the FY 2006 Annual Statement of Assurance. In addition, the Navy stated that it has a discovery effort that will document their business processes, identify relevant controls, standardize processes using compliant systems, provide the appropriate skills for personnel, and ultimately better prepare the Department for audit. This effort is referred to as the Department of the Navy Financial Improvement Program, which is part of the broader Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer-led Financial Improvement and Audit Readiness initiative.

Audit Response. The Navy comments were responsive. We did not review the Navy Financial Improvement Program. However, we agree that the Navy efforts should improve controls over contract financing payments if the scope of the improvement program includes contract financing payments.

C.2. We recommend that the Director of Defense Finance and Accounting Service Cleveland:

a. Develop tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses identified in Finding B of this report, and

Management Comments. The Director, Accounting Services partially concurred with the recommendation. He concluded that processes and controls have improved since the initial finding, that this is not a material weakness, and that further tests of those controls are unnecessary. He stated that staffing has stabilized, and experienced senior staff members are extracting data from the STARS suite of systems. Additionally, STARS data extraction queries are validated to include the correct accounting periods by supervisory review. The current development and preparation of a desktop operating procedure will aid future staffing changes in accurately capturing data from STARS.

Audit Response. The Director's comments were partially responsive. We agree that desk procedures and supervisory review will improve the controls. However, until such time as the controls are implemented, DFAS should continue to test controls related to these weaknesses. We request that the Director reconsider his position on the recommendation and provide comments on the final report

b. Report the material weakness identified in Finding B of this report in its Annual Statement of Assurance.

Management Comments. The Director, Accounting Services nonconcurred with the recommendation. He stated that controls are now in place to ensure that personnel will accurately pull data from STARS to support the STARS portion of the Navy Outstanding Contract Financing Payment balance. DFAS agreed that a portion of the data was previously overlooked, but the amounts were not material in relation to the total value of outstanding contract financing on the Department of the Navy's Balance Sheet.

Audit Response. The Director's comments were not fully responsive. The controls that the Director mentioned were not in place during the audit and will not be in place until February 2007, according to his comments. The audit showed that these weaknesses are material. Until controls are in place and it has been determined that they are operating effectively, DFAS should report a material weakness related to the contract financing balance. We request that the Director reconsider his position on the recommendation and provide comments on the final report

C.3. We recommend that the Director of Defense Finance and Accounting Service Kansas City:

a. Develop tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses related to the Marine Corps identified in Finding B of this report, and

Management Comments. The Director, Accounting Services partially concurred with the recommendation. He stated that internal controls are routinely assessed and tested based on compliance guidelines. He also stated that DFAS has established standing procedures to both correct existing weaknesses and to identify and take appropriate actions to correct newly discovered weaknesses. He believed that a material weakness did not exist and that corrective actions to address this discrepancy have been implemented.

Audit Response. The Director's comments were responsive. If additional written guidance has been created, then the internal controls have been strengthened and no additional action is necessary.

b. Report the Marine Corps material weakness identified in Finding B of this report in its Annual Statement of Assurance.

Management Comments. The Director, Navy Accounting Services nonconcurred with the recommendation. He stated that the errors occurred as a result of a misinterpretation of existing guidance and that the policy has been corrected.

Audit Response. The Director's comments were responsive. Even though he nonconcurs that a material weakness existed, the corrective actions taken to issue new written guidance should correct this material weakness.

Appendix A. Scope and Methodology

Contract financing payments are authorized Government disbursements of monies to a contractor prior to the delivery of supplies or services by the Government. The Navy reported \$4.7 billion as an Outstanding Contract Financing balance in FY 2004. The balance is a part of the amount reported in the FY 2004 Balance Sheet as “Other Assets.” We did not examine all of the data included in the FY 2004 Outstanding Contract Financing balance, but we did review the detailed transactions from the first six months of FY 2004 to evaluate the Navy process for deriving the balance. The Navy reported \$6.7 billion of contract financing payments for the first 6 months of FY 2004. This amount included \$5.1 billion maintained by Naval Air System Command and \$1.6 billion maintained by the Defense Finance and Accounting Service. The Naval Air System Command data are maintained at Patuxent River, Maryland, and the Defense Finance and Accounting Service data are maintained at Cleveland and Kansas City Centers.

We used the entire Naval Air Systems Command (NAVAIR) database of contract financing payments to determine whether the FY 2005 process is operating effectively. We reconciled MOCAS transactions for contract financing with the ERP and STARS transactions for first and second quarter of FY 2004. We matched MOCAS records to ERP records by contract number, dollar amount, transaction date, voucher number, and Accounting Classification Reference Number.

We performed this audit from October 2004 through August 2005 in accordance with generally accepted government auditing standards.

We did not audit any detailed transactions related to the Marine Corps Advances and Prepayments account. We also did not test the transactions in the Navy disbursement tracking system and we did not attempt to audit the entire Navy Outstanding Contract Financing balance.

Use of Computer-Processed Data. We used computer-processed data from MOCAS, STARS, and ERP to perform this audit. We compared MOCAS to ERP and STARS. Although we did not perform a formal reliability assessment of the MOCAS data, we determined that the information in MOCAS relating to the contract financing was generally reliable. ERP and STARS contract financing data was not reliable. See Findings A and B for the discussion of the unreliability of ERP and STARS data. We used Navy disbursement tracking system data but did not test the reliability. This did not affect our audit results.

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

Prior Coverage

No prior coverage has been conducted on accuracy of Navy Outstanding Contract Financing balance during the last 5 years.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Director, Program Analysis and Evaluation

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Naval Inspector General
Commander Naval Air Systems Command

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Finance and Accounting Service

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
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

Department of the Navy Comments



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D C 20350-1000

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MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING, DEPARTMENT
OF DEFENSE


Subj: DODIG DRAFT AUDIT REPORT ON "ACCURACY OF NAVY CONTRACT
FINANCING AMOUNTS" (PROJECT NUMBER D2005FJ-0038)

Ref: (a) DoDIG memo of 14 Sep 05

Encl: (1) Department of the Navy Response to DoDIG Draft Audit
Report

By reference (a), you provided subject draft audit report
for review and comment. Enclosure (1) contains responses to the
findings and recommendations.

My point of contact for this draft audit is Ms. Nancy
Carpenter at (202) 685-6719, nancy.carpenter@navy.mil or Mr.
Steve Sninsky at (202) 685-6733, steve.sninsky@navy.mil.


MARK E. EASON
Director
Office of Financial Operations

**DEPARTMENT OF THE NAVY
RESPONSE TO DODIG DRAFT AUDIT REPORT
ON ACCURACY OF NAVY CONTRACT FINANCING AMOUNTS
(PROJECT NO. D2005FJ-0038)**

Finding A: The \$5.1 billion included by Naval Air Systems Command (NAVAIR) as its portion of the contract financing balance on the Navy's second quarter FY 2004 financial statement was not fully supported and did not reflect all amounts of contract financing transactions associated with NAVAIR. This occurred because NAVAIR did not establish a process to accurately report contract-financing transactions in FY 2004. While NAVAIR made adjustments to the process during the audit to correct these weaknesses, the current process still had weaknesses.

The 2004 NAVAIR process included:

- an unsupportable beginning balance of \$3.8 billion,
- an apparent duplicate posting of \$8.2 billion (absolute) of transactions that occurred in the 4th quarter of FY 2003, and
- the exclusion of \$2.5 billion (absolute) of valid contract financing transactions that occurred in the first quarter of FY 2004.

The 2005 NAVAIR process included:

- a lack of adequate written procedures,
- a lack of adequate supporting evidence for \$458.2 million (absolute), and
- the exclusion of valid transactions totaling \$66.5 million (absolute) that were not posted to the accounting system.

Although NAVAIR improved its reporting procedures FY 2005, a lack of controls over the contract financing transactions that comprise the balance remained. As a result, the Navy could not demonstrate its contract financing balance for FY 2004 was correct and will not be able to assert that the FY 2005 and future balances will be accurate until improvements are made.

NAVAIR Comments: Concur. When the NAVAIR Enterprise Resource Planning (ERP) accounting system (SIGMA) stood up and replaced the Standard Accounting and Reporting System

Enclosure (1)

(STARS) Headquarters Claimant Module (HCM) and STARS Field Level (FL) as the system of record, not all transactions were transferred to SIGMA. Some of the history data was not converted into SIGMA and was left in the STARS systems with access remaining for NAVAIR data. The decision was made to work off the old data in the STARS systems through Defense Finance and Accounting Service (DFAS) rather than convert and bring forward all of NAVAIR's documentation history.

When transactions first started coming in to SIGMA from the Mechanization of Contract Administration System (MOCAS) through an interface that had been built, these transactions came through without signs (+or -), which caused the large absolute balance and duplicate postings in the first year of SIGMA ERP operations. The problem was recognized and corrected with input and collaboration from DFAS. Additionally, system problems remained in progress payment accounting and could not be rectified with DFAS as no immediate solution was available in either the legacy or new ERP system, SIGMA, thereby causing NAVAIR to expense progress payments as a matter of policy (DFAS) until a more permanent solution could be found. This policy continues today.

The MOCAS system also has adjustments made to NAVAIR data after submission, but without those adjustments being sent back to the NAVAIR SIGMA accounting system, causing discrepancies in the financial records between that recorded in NAVAIR's SIGMA and that recorded at U. S. Treasury Department (Treasury). Additionally, reporting time differences remain between data submission at the NAVAIR level and that submitted to Treasury on NAVAIR's behalf. DFAS accelerated financial reporting schedules require that NAVAIR submit its information in accordance with a rigid closing schedule to allow time for DFAS to collect, reconcile, and adjust data before submission to Treasury. This schedule can cause time lags in month-end reporting of up to several days each month between data that NAVAIR submits and data that DFAS submits to Treasury.

While the obligations and expenditures of contracts are properly recorded in SIGMA, the postings of 6W transactions from the paying system, MOCAS, are not easily recognizable due to the adjustments and eliminating entries made by DFAS. Accordingly, NAVAIR has adopted a process that utilizes DFAS management system, Cash History On-Line

Operator Search Engine (CHOOSE) to identify those transactions that have been reported to Treasury and identified as belonging to NAVAIR. This ensures that NAVAIR's financial statements are in line with that of Treasury with proper reflection against our cash balance. Until the problems systemic to progress payments can be rectified by DFAS, these transactions will continue to be reported as expenses on NAVAIR's books rather than advances.

Recommendation A.1.a: We recommend that the Commander NAVAIR direct the establishment of written procedures for preparing the contract financing balance, including the retention of a proper audit trail.

NAVAIR Comments: Concur. As verified by this audit, the treatment of contract financing (progress payments classified with transaction type 6W) in DON accounting systems is flawed. These systems include STARS HCM, STARS FL and the NAVAIR ERP SIGMA System. NAVAIR requested advice as to the proper treatment of these payment records and was advised by DFAS Cleveland to treat them as expenses until a solution has been determined. Several SIGMA system issues have also been discovered and addressed during the three years since we transferred our General Fund accounting system of record from STARS HCM and FL to SIGMA ERP.

The audit did not extend to all of the records resident in the MOCAS, but during auditors' meetings at NAVAIR, they stated they had validated some transactions sent to Treasury from MOCAS and then to SIGMA were not appropriate. There were exclusions of adjustments made to MOCAS that should have been forwarded to SIGMA and Treasury as well as the forwarding of transactions that should not have been sent externally.

As a result of our research and reconciliations, we have determined that for financial reports, we should use data from Treasury in order to more accurately reflect those payments made to vendors. We have developed written procedures for this to ensure the same documented method is used for each report. We also have instituted a process to validate the ending balance of the prior year with the beginning balance of the reporting year. NAVAIR has strengthened the basic information technology controls around the cash file receipt, subsequent file management,

and internal posting of transactions received from DFAS. These improvements include the application of a serial number to each record entering the Systems Applications and Products in Data Processing (SAP) environment (SIGMA) indicating the file on which it was received and its position in the file. This has proven to be a reliable control mechanism to prevent the omission or duplication of processing inbound records. Another process improvement is a confirmation between NAVAIR and DFAS that the number of records sent equals the number of records received via the daily transmissions.

Amounts reported to Treasury could differ from SIGMA balances due to timing and non-receipt of transactions from Treasury. The DFAS accelerated reporting requirement for financial statements precludes keeping SIGMA open long enough at month-end to receive all transactions through its interfaces prior to the end of an accounting period. Therefore, we are using the CHOOSE data to report all transactions in Treasury records as our substantiation for the NAVAIR statement balance.

A proper audit trail is in place and will be used in subsequent reconciliations performed. Estimated date of completion is 30 June 2006.

Recommendation A.1.b: We recommend that the Commander NAVAIR direct the establishment of procedures for including all supportable, valid contract-financing transactions into the ERP database, such as performing a reconciliation of ERP transactions to MOCAS transactions.

NAVAIR Comments: Concur. The DON expenditure process prior to the existence of SIGMA was not altered significantly. All transactions for DON appropriations are forwarded to Navy Supply Information Systems Activity in Mechanicsburg, Pennsylvania. Part of the implementation process for SIGMA included a "splitter" program to redirect all NAVAIR transactions from DFAS to SIGMA vice being sent to STARS HCM or STARS FL. Subsequent to this program being activated, we determined that some accounts were not included in the splitter program and have taken corrective action to have them included. DFAS Cleveland and NAVAIR Comptroller staffs have an on-going effort to reexamine this process as part of a joint Lean Six SIGMA team. This group has representatives from DFAS Cleveland, Charleston, San Diego, Columbus, ASN(FM&C)/FMO and NAVAIR and plans to

perform an end-to-end review of the disbursements process. This process will require the close cooperation and collaboration of DFAS. We believe, given the current DFAS Lean Six SIGMA Black Belt effort in this area, that an estimated completion date of 30 June 2006 is probable.

Additional NAVAIR Comments: We further recommend the development of a mechanized reconciliation process between the MOCAS, Treasury, and SIGMA data to ensure records are in agreement. This process would prove very valuable in the structure of the future Navy ERP.

For the Management Control Program (MCP) inclusion, given that the completion dates for the action fall before the next MCP reporting cycle, it would not be prudent at this time to include these actions. If a material weakness continues beyond the completion date of the aforementioned actions, management will consider adding the information to our FY 2006 MCP Statement of Assurance.

Recommendation C.1.a: ASN(FM&C) develop tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses identified in Finding A of the report.

ASN(FM&C) Comments: Concur. ASN(FM&C) will work with NAVAIR via CNO to ensure development of tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses identified in Finding A of the report.

Recommendation C.1.b: ASN(FM&C) report the material weaknesses identified in Finding A of the report in the Navy's Annual Statement of Assurance.

ASN(FM&C)/CNO Comments: Concur, with the following comments. The FY 2005 Department of the Navy (DON) Statement of Assurance (SOA) did not include this specific material weakness, as the SOA process identifies material weaknesses using a bottom-up reporting approach. The assessable units of the DON MCP comprise the fifteen Echelon 1 organizations reporting to the Secretary of the Navy. NAVAIR is an assessable unit under the Chief of Naval Operations (CNO), an Echelon 1 organization. For FY 2005, Contract Financing was not reported by NAVAIR to CNO; therefore, CNO could not report nor consider reporting the

weakness to ASN(FM&C) for inclusion in the FY 2005 DON Annual SOA.

In addition to self-reported weaknesses submitted by assessable units to their next highest echelon, the DON SOA process relies on audit reports from the Naval Audit Service (NAVAUDSVC), the Government Accountability Office (GAO) and Department of Defense Inspector General (DoDIG). The Office of Financial Operations (FMO) reviews audit reports on a quarterly basis to determine whether the findings contained in those reports constitute material weaknesses for the DON. This determination is based on a variety of factors, including mission impacts, financial materiality, indication of DON-wide and ineffective or missing controls. The issue of Contract Financing at NAVAIR will be reviewed as part of the DON's quarterly audit review process to determine if it should be included in the FY 2006 Annual SOA.

Finally, the primary findings in this report highlight one example of many issues that the DON is addressing through a discovery effort that will document our business processes, identify relevant controls, standardize processes using compliant systems, provide the appropriate skills for personnel, and ultimately better prepare the Department for Audit. This effort is referred to as the Department of the Navy Financial Improvement Program (DON FIP), part of the broader USD (Comptroller) lead FIAR initiative. In the FY 2005 SOA, the DON chose to segment the former weakness relating to the Accuracy of Financial Statements into more manageable categories of Accounts Payable, Environmental Liabilities, Military Equipment Reporting, and Valuation of Inventory and Operating Materials and Supplies, using progress in the FIP to evaluate progress and manage remediation efforts. As discussed above, we will evaluate this area in determining future SOA weaknesses. The goal of the FIP effort is improved financial information for decision-making with an ultimate and measurable outcome being a positive audit opinion. Unfortunately, nowhere in the report was the FIP or FIAR highlighted.

Defense Finance and Accounting Service Cleveland Comments



DEFENSE FINANCE AND ACCOUNTING SERVICE
1240 EAST NINTH STREET
CLEVELAND OHIO 44199

DEC 05 2005

DFAS-A/CL

MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE FINANCIAL AUDITING
SERVICE

SUBJECT: DoDIG Draft Audit on "Accuracy of Navy Contract Financing Amounts,"
(Project D2005FJ-0038), dated September 14, 2005

Our response to the subject audit for recommendations B.1 a, B.1 b, B.2, B.3, C.2 a,
C.2 b, C.3 a and C.3 b is attached. The point of contact is Mr. Jerry Shea, (703) 601-3021 or
DSN 329-3021.

E. J. Krushinski
Director, Accounting Services

Attachment:
As stated

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DFAS Comments to DoDIG Draft Report, Project D2005FJ-0038, "Accuracy of Navy Contract Financing Amounts," dated September 14, 2005

Recommendations Related to Finding B. Defense Finance and Accounting Service Process for Reporting Navy Contract Financing.

Recommendation B.1.a. We recommend that the Director of Defense Finance and Accounting Service Cleveland establish policies to retain detailed documentation that supports reported Outstanding Contract Financing balances. A reconciliation of posted transactions to the Mechanization of Contract Administration Service records would have identified this weakness.

Management Comments. Partially Concur. For the Navy General Fund (GF) Audited Financial Statements (AFS), DFAS retains data queries of the systems Standard Accounting and Reporting System (STARS) Field Level (FL) / Headquarter Claimant Module (HCM), and queries account balances at a specific point in time. Account balances are representations of transactions that were posted to the accounting systems. The support GF AFS retains consists of account balance queries, which are stored in the Accounting Operations Local Area Network (LAN) shared drive and on writeable CD's at the end of each financial quarter/year. GF AFS Accounting Operations is a financial reporting function and reports on account balances, which are a result of transactional events.

DFAS is presently developing a reconciliation process between Treasury related Defense Cash Accountability System (DCAS) files and the STARS Accounting System. The development of this process will ensure the matching of data between transactions processed by the Mechanization of Contract Administration Service (MOCAS) through Treasury to the STARS Accounting System.

Estimated Completion Date. February 1, 2007

Recommendation B.1.b. We recommend that the Director of Defense Finance and Accounting Service Cleveland establish policies to ensure that all valid contract financing transactions are included in the Outstanding Contract Financing balances, including appropriations and subheads. A complete reconciliation of transactions posted to the financial statements and the Mechanization of Contract Administration Service transactions would have identified this weakness.

Management Comments. DFAS considers this recommendation, as worded, to be all inclusive and there would be a benefit to dividing it into specific recommendations and addressed to the responsible area of DFAS. In an effort to break this out, we are providing a response below to each of the specific findings as noted in the report.

1. Specifically, DFAS could not provide supporting documentation for the change it made to the contract financing balance from FY 2003 through the second quarter of FY 2004.

Management Comments. Non-Concur. DFAS provided the DoD IG the supporting documentation for account balances from queries of the STARS suite of systems. DFAS submitted a Task Order (01-05-803) on November 29, 2004, which referenced the necessary data elements, for the referenced audit. The information requested was based on a timeframe from October 1, 2003, through March 31, 2004. The data elements included the following: Contract Number, Shipment Number (if available), Posted Date, ACRN, Dollar Value, Voucher Number, Department, Appropriation, BFY, EFY, and Subhead. The information was provided to DoD IG on December 27, 2004.

2. Specifically, DFAS inappropriately excluded transactions associated with FY 2003 appropriations when calculating the beginning balance for FY 2004.

Management Comments. Concur. DFAS responds that errors occurred during the data extraction process in FY 2003 due to new staff inexperience and changes in personnel. Since that time an experienced senior staff member performs the data extraction. Controls are in place to ensure that all open program years data is included in the STARS data extracts. The responsible accountant is drafting a data extraction desktop operating procedure.

Estimated Completion Date. February 1, 2006

3. Specifically, DFAS inappropriately excluded all contract financing transactions that occurred in March 2004, certain STARS subheads, and other miscellaneous contract financing transactions.

Management Comments. Partially Concur. DFAS responds that the contract financing transactions occurring in March 2004 were excluded and that errors occurred during the data extraction process in FY 2004 due to staff inexperience and changes in personnel. Since that time an experienced senior staff member performs the data extraction. The error involved timing for the data extraction and the data was pulled before the system had completed the month end roll. Controls are in place to ensure that the current accounting closing month is included in the STARS data extracts. The responsible accountant is drafting a data extraction desktop operating procedure. However, DFAS submitted to the DoD IG on December 27, 2004, a data file containing MOCAS transactions based on required data elements identified in 1 above.

Estimated Completion Date. February 1, 2006

4. Specifically, DFAS inconsistently reported or inappropriately excluded contract financing transactions related to the Marine Corps.

Management Comments. Concur. This finding, as written, refers to DFAS as a whole. We infer from the report that the finding is in two parts - the misclassification of the MOCAS transactions coded with "6W" and the exclusion of certain Marine appropriations or Navy appropriations with Marine subheads. For the misclassification, DFAS acknowledges that we misclassified the "6W" payments as prepayments instead of contract financing payments due to a misinterpretation of accounting standards with the result that the wrong general ledger attribute was used causing incorrect information on footnote 6. Written policy, previously established, has been revised to reflect this change and prevent this from reoccurring. For the second condition, the exclusion, we infer that the phrase "inappropriately excluded" refers to the Marine Corps Research, Design, Test and Evaluation and Navy Procurement appropriations with Marine Corps subheads, as referenced on page 13 by the DoD IG. DFAS concurs and will set up procedures to capture and report the Marine Corps subheads for these appropriations.

Estimated Completion Date. February 1, 2006.

5. Specifically, DFAS inappropriately included transactions that were not supportable.

Management Comments. Non-Concur. DFAS submitted to the DoD IG on December 27, 2004, a data file containing MOCAS transactions based on requested criteria. The STARS system generated an output file which contained the required data elements identified in 1 above. The information was keyed on USSGL Account 1450.0300, "Progress Payment Made to Others."

Recommendation B2. We recommend that the Director of Defense Finance and Accounting Service Kansas City establish a written policy to report contract financing transactions that is consistent with the Federal Accounting Standards for reporting contract financing transactions.

Management Comments. Concur. DFAS reported the amounts in question as prepayments instead of contract financing payments. It should be noted that accurate amounts were posted and reported on the correct line of the financial statements, but due to a misinterpretation of accounting standards, the amounts were reported using an incorrect general ledger attribute causing incorrect information in the footnotes. Written policy, previously established, has been revised to reflect this change.

Completed. November 22, 2005.

Recommendation B.3. We recommend that the Director, Defense Finance and Accounting Service assign responsibility to the appropriate staff for reporting Marine Corps contract financing transactions related to the Navy Procurement and Research, Design, Test, and Evaluation procurements and issue policy that those amounts be reported separately from advances and prepayments on the balance sheet

Management Comments. Partially Concur. As mentioned in management comment 4 to Finding B, DFAS will set up procedures to capture and report the Marine Corps subheads for these appropriations. However, while we support proper disclosure, we do not favor the recommended further breakout on the balance sheet. The design in the department's financial statement presentation is in accord with the Office of Management and Budget's Form and Content regulation A-136 and with the United States Standard General Ledger crosswalks of the Department of the Treasury. In these references, the balance sheet aggregates all the contract financing payments, advances and prepayments together as Other Assets. We support the prevailing practice of utilizing the footnotes as the place to provide greater degrees of disclosure. In this case, the format of footnote 6 provides clear and separate disclosure distinguishing contractor financing payments on line 2A from advances and prepayments on line 2B.

Estimated Completion Date. DFAS will set up procedures to capture and report the Marine Corps subheads for these appropriations by February 1, 2006.

Finding C. Navy and Defense Finance and Accounting Management Control Program.

Recommendation C.2 a. We recommend that the Director of Defense Finance and Accounting Service Cleveland develop tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses identified in Finding B of this report.

Management Comments. Partially Concur. DFAS concludes that processes and controls have improved since the initial finding, that this is not a material weakness for Accounting Operations financial statement preparations processes, and that further tests of those controls are unnecessary. DFAS GF AFS staffing has stabilized and experienced senior staff members are extracting data from the STARS suite of systems. STARS data extraction queries are validated to include the correct accounting periods by supervisory review. The STARS systems accounting month closing is validated by communication with the Divisions Systems Scheduling Branch. The current development and preparation of a desktop operating procedure will aid future staffing changes in accurately capturing data from STARS.

Estimated Completion Date. February 1, 2006.

Recommendation C.2.b. We recommend that the Director of Defense Finance and Accounting Service Cleveland report the material weakness identified in Finding B of this report in its Annual Statement of Assurance

Management Comments. Non-Concur. DFAS Accounting Operations does not concur that this is a material weakness. Controls are now in place ensuring that GF AFS accurately queries STARS for the data that should represent the portion of the Outstanding Contract Financing Payment balances from the STARS suite of systems. However, GF AFS agrees that a portion of the data was previously overlooked, but that these amounts were not material in relation to the total value of outstanding contract financing on the Department of the Navy's balance sheet.

Recommendation C.3.a. We recommend that the Director of Defense Finance and Accounting Service Kansas City develop tests to determine whether internal controls have been designed and implemented to prevent the material weaknesses related to the Marine Corps identified in Finding B of this report.

Management Comments. Partially Concur. As previously discussed, this situation arose due to a misinterpretation of established policy. Internal controls are routinely assessed and tested based on FMFIA compliance guidelines. We also have established standing procedures in place to both correct existing weaknesses and identify and take appropriate actions to correct newly discovered weaknesses. We feel that a material weakness did not exist and this situation and those corrective actions to address this discrepancy have been implemented with the new procedures already in place for reporting.

Completed. November 22, 2005

Recommendation C.3.b. We recommend that the Director of Defense Finance and Accounting Service Kansas City report the Marine Corps material weakness identified in Finding B of this report in its Annual Statement of Assurance.

Management Comments. Nonconcur. As previously explained a misinterpretation of existing guidance created the discrepancy. Our policy has been changed to clarify the correct procedure and we are now correctly reporting.

The DoDIG audit team did not physically audit at Kansas City. Telephone interviews were conducted with the Supervisor, Audited Financial Statements Branch. We were not aware, until the draft audit report was issued that audit findings were developed and recommendations were made.

Team Members

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

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