

# Inspector General

United States  
Department *of* Defense



### **Additional Copies**

To obtain additional copies of this report, visit the Web site of the Department of Defense Inspector General at <http://www.dodig.mil/audit/reports> or contact the Secondary Reports Distribution Unit at (703) 604-8937 (DSN 664-8937) or fax (703) 604-8932.

### **Suggestions for Future Audits**

To suggest ideas for or to request future audits, contact the Office of the Deputy Inspector General for Auditing at (703) 604-9142 (DSN 664-9142) or fax (703) 604-8932. Ideas and requests can also be mailed to:

ODIG-AUD (ATTN: Audit Suggestions)  
Department of Defense Inspector General  
400 Army Navy Drive (Room 801)  
Arlington, VA 22202-4704

DEPARTMENT OF DEFENSE

**hotline**

**To report fraud, waste, mismanagement, and abuse of authority.**

Send written complaints to: Defense Hotline, The Pentagon, Washington, DC 20301-1900  
Phone: 800.424.9098 e-mail: [hotline@dodig.mil](mailto:hotline@dodig.mil) [www.dodig.mil/hotline](http://www.dodig.mil/hotline)

### **Acronyms**

AAFES	Army and Air Force Exchange Service
CFSC	Community and Family Support Center
CIP	Construction-in-progress
CNIC	Commander, Navy Installations Command
DFAS	Defense Finance and Accounting Services
OIG	Office of Inspector General
FASAB	Federal Accounting Standards Advisory Board
FMR	Financial Management Regulation
GAAP	Generally Accepted Accounting Principles
GAGAS	Generally Accepted Government Auditing Standards
GLAC	General Ledger Account Code
MCCS	Marine Corps Community Services
MWR	Morale, Welfare, and Recreation
NAFI	Nonappropriated Fund Instrumentalities
OUSD(C)/CFO	Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer
RAMCAS	Recreation and Mess Central Accounting System
SAFIS	Services Agency Financial Information System
SFFAS	Statement of Federal Financial Accounting Standards
SOW	Statement of Work



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

MAR 01 2007

MEMORANDUM FOR PRINCIPAL DEPUTY UNDER SECRETARY OF DEFENSE  
FOR PERSONNEL AND READINESS  
UNDER SECRETARY OF DEFENSE  
(COMPTROLLER)/CHIEF FINANCIAL OFFICER

SUBJECT: Report on the Agreed-Upon Procedures Covering the Financial Reporting  
for Nonappropriated Fund Instrumentalities and Related Activities  
(Report No. D-2007-063)

We are providing this report for your information and use. No written response to this report was required, and none was received. Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the staff. Questions should be directed to me at (703) 325-5782 (DSN 221-5782) or Mr. Joseph Guba at (703) 325-0433 (DSN 221-0433). The team members are listed inside the back cover. See Appendix F for the report distribution.

By direction of the Assistant Inspector General for Auditing:

A handwritten signature in black ink, reading "Paul J. Granetto", is written over a horizontal line.

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

## Department of Defense Office of Inspector General

**Report No. D-2007-063**

**March 1, 2007**

(Project No. D2006-D000FH-0120.000)

### **Agreed-Upon Procedures Covering the Financial Reporting for Nonappropriated Fund Instrumentalities and Related Activities**

## **Executive Summary**

**Who Should Read This Report and Why?** This report is intended solely for use by officials in the Office of the Principal Deputy Under Secretary of Defense for Personnel and Readiness (Policy Office) and officials in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer (OUSD[C]/CFO). The report discusses the results of the procedures that auditors in the DoD Office of Inspector General performed as agreed upon with the Principal Deputy Under Secretary of Defense for Personnel and Readiness.

**Background.** According to DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” November 22, 2005, the Policy Office “shall develop, promulgate, and monitor compliance with policy and other guidance to determine proper administration of Nonappropriated Fund Instrumentalities (NAFIs) and management of their resources.” The Policy Office performs an annual review of the NAFI consolidated Program Group<sup>1</sup> financial statements (Report)<sup>2</sup> forwarded to their office by the Military Services. During the review of the FY 2004 Reports, the Policy Office discovered accounting discrepancies including unreconcilable equity transfers between headquarters and field activities, noncompliance with DoD accounting policy for NAFI construction-in-progress, and prior-period adjustments. Based on the Policy Office findings and in response to the President’s Management Agenda of establishing a goal of achieving an unqualified audit opinion, the Policy Office took the initiative to achieve the same for the NAFI Program Groups under their purview. The Policy Office requested that auditors in the DoD Office of the Inspector General perform procedures to review the financial reporting practices for NAFI. The procedures reviewed four primary areas: DoD policies, accounting for construction-in-progress, eliminating entry transactions between headquarters and installations or regions and between headquarters funds, and prior-period adjustments. This report discusses the agreed-upon procedures, auditor actions, and the results of our review of NAFI financial reporting practices.

**Results.** DoD policy needs to be changed to improve clarity and to assist the NAFIs in uniformly applying generally accepted accounting principles. See Appendix D for the suggested changes to DoD regulations, directives, and instructions for which the Policy

---

<sup>1</sup>DoD Instruction 1015.14 paragraph 4.3 provides that DoD programs or activities and their supporting NAFIs are classified into one of six Program Groups which are Military Morale, Welfare, and Recreation, Armed Services Exchange Programs, Civilian Military Morale, Welfare, and Recreation, Lodging Program, Supplemental Mission Funds, and Special Purpose Central Funds.

<sup>2</sup>The Military Services refer to these Reports as 1015.15 submissions, so for the purposes of this report, we will refer to these documents as Reports.

Office is responsible. See Appendix E for the suggested changes to policy for which OUSD(C)/CFO is responsible.

The Army was not accounting for construction-in-progress as an asset, but was expensing the costs instead. After our review, the Army chose to change its construction-in-progress accounting policy and capitalize the costs incurred. Consequently, the Army proposed to record an adjusting entry with an estimated value of \$135 million and to reverse the expensed amount for the active construction projects. The overall policies and procedures of the Navy, Air Force, and Marine Corps for construction-in-progress complied with generally accepted accounting principles and were consistent with established DoD policies. However, our review of prior audit coverage performed by entities other than the DoD Office of Inspector General documented numerous audit findings that reflect the failure of the Military Services to follow that guidance.

In FY 2005, with the exception of the Army and Marine Corps, the Military Services followed generally accepted accounting principles for eliminating entry transactions between headquarters and installations or regions and between headquarters funds. The Army could not provide appropriate documentation to support its transactions as requested, and the Marine Corps had an unusually large number of journal entries indicating a failure to accrue financial transactions during the current period. The Marine Corps' financial management practice indicates the use of a modified cash basis method of accounting, which is not in accordance with generally accepted accounting principles.

For prior-period adjustments (equity transactions), in some cases, the Reports properly disclosed the material adjustments submitted to the Policy Office, but the Army, Navy, and Marine Corps are distorting their income statements by charging current year operating expenses to equity. In addition, the Military Services did not comply with DoD Instruction 1015.15, "Procedures for Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources," May 25, 2005, paragraph 5.4.2.4, which establishes allowable equity transactions (prior-period adjustments).

**Management Comments.** We provided a draft report on December 15, 2006. No written response to this report was required. No management comments were received.

# Table of Contents

---

<b>Executive Summary</b>	i
--------------------------	---

## **Independent Auditor's Report**

Overview	1
Agreed-Upon Procedures, Auditor Actions, and Results	11

## **Appendixes**

A. Scope and Methodology	16
B. Prior Coverage	18
C. Other Matters of Interest	21
D. Memorandum to Principal Deputy Under Secretary of Defense for Personnel and Readiness	28
E. Memorandum to Under Secretary of Defense (Comptroller)/Chief Financial Officer	49
F. Report Distribution	68

---

# Independent Auditor's Report

## Overview

DoD Instruction 1015.14, "Establishment, Management and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources," November 22, 2005, paragraph 5.2, places the Principal Deputy Under Secretary of Defense for Personnel and Readiness (Policy Office<sup>3</sup>) responsible for nonappropriated fund policy and DoD Military and Civilian Morale, Welfare, and Recreation (MWR) programs, military exchange services, and other authorized Nonappropriated Fund Instrumentalities and Related Activities (NAFIs). Further, DoD Instruction 1015.14, paragraph 5.2.1, states that the Policy Office is responsible for developing, promulgating, and monitoring compliance with policy and other guidance to determine proper administration of NAFIs and management of their resources.

The Policy Office performs an annual review of the NAFI consolidated Program Group financial statements (Report)<sup>4</sup> forwarded to their office by the Military Services. DoD Instruction 1015.15 "Procedures for Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources," May 25, 2005, required the Military Services to file these submissions with the Policy Office. During the review of the FY 2004 Reports, the Policy Office discovered accounting discrepancies including unreconcilable equity transfers between headquarters and field activities, noncompliance with DoD accounting policy for NAFI construction-in-progress, and prior-period adjustments. In response to the President's Management Agenda, the Policy Office established a goal of achieving an unqualified audit opinion for their NAFI Program Groups. The Policy Office requested that auditors in the DoD Office of Inspector General (DoD OIG) perform agreed-upon procedures to review the financial reporting practices for NAFI. The agreed-upon procedures included four primary areas: DoD policies, accounting for CIP, eliminating entry transactions between headquarters and installations or regions and between headquarters funds and prior-period adjustments. This report discusses the agreed-upon procedures, auditor actions,

---

<sup>3</sup>DoD instructions use the acronym PDUSD(P&R) as the official acronym for the Policy Office.

<sup>4</sup>DoD Instruction 1015.15, "Procedures for Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources," May 25, 2005, paragraph 5.5.2 states the following: "A consolidated financial and management report shall be prepared annually for each Military Service, and Joint Service NAFI. Each consolidated report shall contain the financial statements and reports specified at enclosure 7. Ten copies of the annual report shall be submitted to the PDUSD(P&R) within 120 days following the close of the Program Group fiscal year. The reports shall be based on or be the basis of annual financial statements that comply with the audit requirements of DoD Instruction 7600.6..."

and the results of those actions used to review the financial reporting practices of the NAFIs.

The agreed-upon procedures limited our scope to procedures that did not include tests of the management controls. The sufficiency of these procedures is solely the responsibility of the Policy Office officials. Therefore, we make no representation regarding the sufficiency of the procedures.

The Policy Office did not engage us to perform, and we did not perform, an examination, the objective of which would have been to express an opinion on the data collection methodology or the accuracy of the data collected. Accordingly, we do not express such an opinion. If we had performed additional procedures, other reportable conditions might have come to our attention that we would have reported to the Policy Office. We implemented the agreed-upon procedures in accordance with generally accepted government auditing standards (GAGAS) and attestation standards established by the American Institute of Certified Public Accountants as of August 4, 2006.

## **Program Groups in the NAFI Financial Statements**

To accomplish the review, we established our universe as the Nonappropriated Fund's six Program Groups as defined by DoD Instruction 1015.14, paragraph 4.3. The Program Groups included:

- Military MWR Programs,
- Armed Services Exchange Services Programs (Exchange),
- Civilian MWR Programs,
- Lodging Program Supplemental Mission Funds,
- Supplemental Mission Funds, and
- Special Purpose Central Funds.

To evaluate the completeness of our universe and compliance with DoD guidance, we followed the requirements identified in DoD Instruction 1015.15 and DoD Instruction 1015.14.

## **DoD Accounting Policy Review**

We reviewed the laws, standards, DoD regulations, directives, and instructions that affect financial reporting and the ability of DoD NAFI to obtain an unqualified opinion on their Component-level, consolidated Program Group financial statement for the six Program Groups. We suggested changes to DoD regulations, directives, and instructions that should improve financial reporting and assist the Military Services in obtaining an unqualified audit opinion on their consolidated financial statements for the Program Groups. See Appendix D and



Appendix E for our suggested changes to policy.

## **Accounting for Construction-in-Progress**

According to generally accepted accounting principles (GAAP) and DoD 7000.14, “Financial Management Regulation” (FMR) volume 13, Nonappropriated Funds Policy and Procedures, chapter 3, Assets” August 1994, the CIP account is used to accumulate all qualified, capitalized construction costs until asset completion. On the completion of the asset, the entity transfers the CIP account balance to the proper fixed asset account. The Army expensed construction costs as opposed to capitalizing them. With respect to the other Military Services, we determined that the overall policies and procedures for the Navy, Air Force, and Marine Corps for CIP complied with GAAP and were consistent with established DoD policies. However, the Military Services’ policies are inconsistent regarding the capitalization of interest paid because of conflicting guidance between Statement of Federal Financial Accounting Standards (SFFAS) No. 6 and DoD “FMR, volume 13, Nonappropriated Funds Policy and Procedures,” January 2004. The DoD FMR does not allow NAFI entities to capitalize interest. However, SFFAS No. 6 requires Federal Government entities to capitalize material interest costs paid as part of the fixed asset. Our review of Military Services’ compliance with established CIP guidance follows.

### **Army**

We determined that the Army Headquarters Community and Family Support Center (CFSC) recorded major construction projects as a grant expense during the initial phase of the contract award instead of capitalizing the costs of the project under a CIP account. On completion of the construction project, Army Headquarters transferred the grant expense balance to the installation, which then capitalized the asset under the appropriate asset account. The Army changed its CIP accounting policy as of October 1, 2006. Because of this change, the Army recorded a \$135 million adjusting entry for the estimated value of the active construction projects that had been expensed. Although we did not review or examine the \$135 million adjustment, we concluded that the Army’s revised CIP accounting procedures comply with the relevant guidance, except for not capitalizing interest as part of the CIP cost.

### **Navy**

The Commander, Navy Installations Command (CNIC) manages the accounting for Navy and is responsible for CIP. Overall, the Navy accounting guidance for CIP complied with the relevant guidance except for not capitalizing interest and not adding indirect labor for NAFI employees. The Recreation and Mess Central Accounting System (RAMCAS) guidelines allow improper practices concerning labor capitalization under certain circumstances. The RAMCAS page C-48 states:

Labor costs are included only if the labor is contracted or a NAF employee was hired for the express purpose of performing work to create fixed assets. Do not include the labor cost of NAF employees

working on a fixed asset if the employees would have been on the payroll regardless of whether or not they worked on a fixed asset.

The Navy's fixed assets thresholds were contrary to the values noted in DoD FMR, volume 13. The Navy Section 9.1, "Fixed Assets," of the Bureau of Naval Personnel Instructions (BUPERSINST) 7510.1B classifies a purchase with an acquisition value greater than \$2,500 as fixed assets, but the DoD FMR, volume 13, chapter 3, "Assets" August 1994, classifies a purchase, donation or transfer of a property, plant, and equipment with an acquisition cost greater than \$1,000 as a fixed asset.

Although we reviewed only CIP policy, we did note the following CIP-related problems in the review of prior audit coverage:

- A CIP project totaling \$11.6 million was not reversed upon completion and after occupancy criteria were met.<sup>5</sup>
- Fixed assets were initially recorded as assets in the CIP account, instead of an appropriate fixed asset account for furniture, fixtures, and equipment.<sup>6</sup>

Audited financial statements for FY 2005 Navy Installation Command Central Fund<sup>7</sup> disclosed facility and operating grants disbursements of \$26.9 million and \$13.1 million for FY 2005 and FY 2004, respectively. Navy officials stated, "Probably should re-name these entries since they represent capital and operating grants. These entries are not related to our major construction program. The entries represent either an operating grant or the central purchase of equipment, such as fitness equipment." The DoD FMR, volume 13 states that the transfer of cash or other assets affects equity, and nonmonetary exchanges between NAFI are recorded on the books of the gaining NAFI at the net book value with offsetting entry to equity on both the gaining and the losing NAFI. We concluded that the CNIC accounting practice of treating the transfer of capital for the purchase of equipment as a grant expense misleads the financial statement users, and distorts the financial statements' reliability, relevance, consistency, and comparability.

## Air Force

The Directorate of Financial Management and Comptroller, Headquarters Air Force Services Agency is responsible for all NAFI accounting and financial reporting. Based on our discussions with Air Force officials and analysis of data and guidance, we concluded that the Air Force was accounting for CIP in accordance with the relevant guidance, except for capitalization of interest. We

---

<sup>5</sup>Letter to Audit Committee Members Morale, Welfare, and Recreation Division Navy Personal Command (NAVPERSCOM), dated September 30, 2004, by Grant Thornton LLP.

<sup>6</sup>Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financials Statements, US Navy, Navy Personnel Command Morale, Welfare, and Recreation Division 2003 MWR Site Visits, by Grant Thornton LLP.

<sup>7</sup>Consolidated Financial Statements and Report of Independent Certified Public Accountants CNIC Central Non-appropriated Funds September 30, 2005 and 2004, dated December 9, 2005, by Grant Thornton LLP.

reviewed prior audit reports, which did not reveal any findings related to the Air Force CIP.<sup>8</sup>

## **Marine Corps**

The Marine Corps Community Services (MCCS) is responsible for the Military MWR, Armed Services Exchange, Civilian MWR, and Supplemental Mission Funds Program Groups Reports. Staff at the Navy Annex perform the accounting and reporting for the Marine Corps Transient Billeting Lodging Program (Billeting). Based on our discussions with Marine Corps officials and our analysis of data and guidance, we concluded that the Marine Corps was accounting for CIP in accordance with the relevant guidance, except for:

- capitalizing interest,
- thresholds for procedures capitalizing fixed assets differ from volume 13, chapter 3 of the DoD FMR, and
- fixed asset reserve activity recorded in the equity accounts.

## **Eliminating Entry Transactions**

The Policy Office asked us to review eliminating entry transactions between headquarters and installations or regions and between headquarters funds. We focused on the data integrity and compliance problems for FY 2005. We reviewed the reports for FYs 2003 and 2004 to determine whether potential systemic problems existed within the Military Services.

## **Army**

We requested information from the Army that consolidated the financial information for base level (field activities) and headquarters financial activity into the 1015.15 Reports,<sup>9</sup> however, the Army was unable to provide the requested information. Army officials told us that the 1015.15 submissions were a collection of spreadsheets, not financial statements. Army officials added, “The spreadsheet was a financial report, but not a financial statement.” In addition, Army officials told us that their “submissions are made up of a collection of field and headquarters activities.” Army officials added, “The CFSC tries to eliminate any transactions that take place between the Program Groups; however, actual eliminating entries are not recorded in the Defense Finance and Accounting Services (DFAS) systems.” We asked how the Army confirms the overall integrity of the consolidated financial reports. Army officials responded, “CFSC did not want the auditors to misunderstand that a financial statement existed for the Army’s NAFI nor did CFSC have a document to support the flow of information to the consolidation of spreadsheets, eliminating entries and

---

<sup>8</sup>Air Force officials informed us that the audits were not of a financial nature, but instead the audits were performance reviews. Air Force officials added that the only financial statement audits were performed at the headquarters level.

<sup>9</sup>The Military Services refer to these Reports as 1015.15 Submissions, so for the purposes of this report we will refer to these documents as Report(s).

final 1015.15 submissions.” Army officials consistently told us that they used a manual process to prepare the consolidated Program Group Reports, but they did not retain a copy of that document for the DoD OIG to analyze.

We attempted to follow the flow of information from the Army internal financial systems to the Reports provided to the Policy Office, but we were unsuccessful because the Army lacked eliminating entry transactions data at the account level. Therefore, we could not comment on the reasonableness of the related elimination entry transactions for the Army’s Reports.

The Army does not have an enterprise management system in place. A recent U.S. Army Audit Agency report<sup>10</sup> noted,

Because many organizations are involved in the various facets of accounting and financial management for the Army’s MWR Program, a clear need exists to develop a financial management structure that facilitates IMA’s execution of its mission in concert with its vision. In the same report, U.S. Army Audit Agency continued with, “The current fund structure is segmented and complex, requiring many transactions among multiple funds. The funds were aligned geographically, by command, or through assigned functions. The financial reporting and management of multiple funds creates unnecessary—and avoidable—work and complexities. For example, in the Army MWR Annual Report, the Army MWR Program reported NAF revenues for FY 04 totaling about \$887 million. However, proper accounting for these revenues required the Army to process transactions totaling about \$1.6 billion, or about \$713 million in duplicative interfund transactions.

In summary, the current structure requires multiple transactions between many funds that are aligned geographically, by command, or through assigned functions. We concluded that this lack of an integrated system was a contributing factor in the inability of the Army to respond to our requests for information.

## Navy

The Navy uses the RAMCAS system to accumulate accounting information. RAMCAS does not have a report writer and the CNIC staff prepares each consolidated Program Group report through a manual consolidation process. CNIC officials said they had not retained copies of the supporting documentation used to prepare the financial information included in the consolidated Program Group Reports and would have to recreate the requested information. We were able to review the eliminating entry transactions for FY 2005 and concluded that transactions between headquarters and installations or regions were consistent and properly eliminated during consolidation; transactions between headquarters funds were either properly eliminated during consolidation if they were within the same Program Group or disclosed if they were not within the same Program Group.

CNIC officials were unable to recreate their supporting documentation for the FY 2003 and FY 2004 Military MWR consolidated Program Group Reports. Therefore, we could not comment on the reasonableness of the related elimination

---

<sup>10</sup>U.S. Army Audit Agency Report No. A-2006-141-FFH “Financial Management Structure for the Army Morale, Welfare, and Recreation Program for U.S. Army Installation Management Agency,” June 22, 2006.

entry transactions for these Reports. In addition, we discovered that the Navy Flying Club's financial information is not being included in any Program Group Report. This omission will cause a \$357,060 understatement of NAFI assets.

## **Air Force**

Air Force officials provided us a list of all applicable supporting information for the eliminating entry transactions in a format consistent with generally accepted accounting principles used in the United States of America. We compared the eliminating entry information to the records within the Services Agency Financial Information System (SAFIS) to determine that the appropriate balances were being eliminated as described. We concluded that the eliminating entries were consistent with the type of adjustments for these activities, except that the Civilian MWR Program Group financial statements did not eliminate the Air Force Assessment in FYs 2004 and 2005.<sup>11</sup> In addition, the Special Purpose balance sheet that the Air Force consolidated in the SAFIS system reflects a balance of \$545,266 in an account designated as "Receivables from other NAFIs," but it does not reflect the balance in the FYs 2004 and FY 2005 Reports to the Policy Office.

## **Marine Corps**

The Marine Corps format for their consolidated internal financial statements is consistent with generally accepted accounting principles used in the United States. Based on our analysis of the Marine Corps eliminating entry transactions, we concluded that Marine Corps transactions between headquarters and installations or regions were consistent and properly eliminated during consolidation. In addition, transactions between headquarters funds were properly eliminated if they were within the same Program Group and disclosed if activity was between Program Groups. While these adjustments appear reasonable, the financial statements included far more elimination, reclassification, and adjusting journal entries than would be consistent with common practice. We discussed this issue in Appendix C, "Other Matters of Interest."

## **Prior Period Adjustments**

The Policy Office requested that we review prior-period adjustments (includes equity transactions) to establish whether they were disclosed and properly documented within the annual Reports submitted to the Policy Office.

## **Army**

In response to our request for prior-period adjustments greater than \$50,000, the Army responded, "You have all the identified transactions within program groups regardless of dollar value listed with the packages we gave you in our original meetings. As far as prior-period adjustments, what is the criteria for establishing

---

<sup>11</sup> Assessments are charges between headquarters and field operations, where headquarters records revenues for services levied to the field, which records an expense. Failure to eliminate this activity overstates revenues and expenses.

a threshold of \$50,000? Considering the magnitude of the Services' reported assets or revenue, the amount seems rather arbitrary." In addition, Army officials added that since a materiality threshold does not exist for reporting the inter-Program Group transactions, the Army does not track these transactions and could not provide a list of the transactions in question to the auditors." Because the Army could not provide the requested information, we could not verify whether each of the equity transactions had been properly classified as an equity transaction as required by DoD Instruction 1015.15.

DoD Instruction 1015.15 clearly defines the accounting for capital distributions between Program Groups as equity transfers, not income or expense. For example, the U.S. Army Audit Agency (AAA)<sup>12</sup> reported the following significant overstatement of revenue was caused by an equity transfer being reported as revenue.

The payments from the Army Recreation Machine Program (ARMP) Trust Fund and field MWR activities to the Army MWR Fund weren't related to the sales of goods or services. Therefore because CFSC prepares annual budget guidance and financial reports to support Army MWR as a corporate entity, CFSC should treat the transfers from these other activities as increases to fund equity to the Army MWR Fund. During FY 03 Army MWR Fund accountants reported about \$42.5 million in revenues from other MWR activities. The amount included about \$26.8 million in ARMP Trust Fund distributions and about \$15.7 million in capital reinvestment assessments from field MWR activities. If these amounts had been reported as increases to retained earnings, revenues would decrease from about \$122.3 million to about \$79.8 million.

We concur with the finding of the AAA that these transfers of monies between activities should be recorded as equity transfers, not income, on one set of financial statements and as an expense on the other. Reclassifying equity transfers as program expenses is an incorrect accounting treatment that significantly distorts the income statement and is not in accordance with GAAP.

## **Navy**

We reviewed the list of equity transactions from FYs 2003 through 2005 provided by the Navy, and followed the flow of information to the Reports. For each of the Program Groups reviewed, we noticed material discrepancies between the total of equity transactions that the Navy gave the DoD OIG and the amounts disclosed in the related Reports. The Navy also did not provide adequate descriptions for each of these equity adjustments. Without a description of the adjustment, we could not verify whether each of the transactions had been properly classified as an equity transaction as required by the DoD Instruction 1015.15.

## **Air Force**

We reviewed the list of prior-period adjustments provided by the Air Force and traced that disclosure to the appropriate Report without exception. While all of the prior-period adjustments from the list provided by Air Force were properly

---

<sup>12</sup>U.S. Army Audit Agency Report No.A-2006-0101-FFH, "Attestation Review of Morale, Welfare, and Recreation Financial Statements-Morale, Welfare, and Recreation Fund for U.S. Army Community and Family Support Center," April 27, 2006.

disclosed in the Reports, we noted discrepancies between the internal financial statements and those Reports. We compared the Air Force's definitions for many of its General Ledger Accounts Codes (GLAC) found within the Air Force equity sections to the requirement of the DoD Instruction 1015.15. Based on the information in our comparison, we concluded that many of the definitions and related financial transactions for the Air Force equity GLACs did not comply with DoD Instruction 1015.15. In response to our inquiries about these GLACs, the Air Force stated that although the use of the GLACs may appear contrary to the DoD instruction, their use does not create an accounting issue. These are memo accounts that help Air Force leaders capture a snapshot of future outstanding requirements. We were unable to reconcile the equity accounts in the Air Force SAFIS.

During our conversation with Air Force officials, they noted numerous equity transactions not within the scope of our engagement that were not disclosed, and that the Air Force most likely does not comply with the DoD Instruction 1015.15. Finally, during our review of the financial statements for the Program Groups consolidated in SAFIS, we noted that, in each case, the period-ending account balance for equity did not agree with the subsequent period-beginning balance for equity. We determined that we could not rely on the system for the Equity Accounts.

## **Marine Corps**

We reviewed the list of prior-period adjustments. Taking into consideration that adjustment to equity should be very infrequent, we noticed that the Marine Corps had an unusually high number of equity transactions for each of the audited years that we reviewed:

- 917 transactions for FY 2002,
- 905 transactions for FY 2003,
- 433 transactions for FY 2004, and
- 676 transactions for FY 2005.

The following are a few examples of the approximately 3,000 transactions recorded directly to the equity account during the last 4 fiscal years by the Marine Corps:

- \$865,275 court settlement of a legal action related to El Toro Marine Corps Base, which was officially closed in 1999, were charged as adjustments to equity in the fiscal years reviewed,
- cash reconciliations adjustments charged directly to the equity fund as high as \$150,000,
- \$126,000 of no-year<sup>13</sup> Congressional Appropriation for Deployment Support for Bosnia and Southwest Asia, and given to Marine

---

<sup>13</sup> Budget authority that remains available for obligation for an indefinite period of time, usually until the objectives for which the authority was made available are attained.

Expeditionary Unit Commanders before deployment, for Local Tours and Recreation, and

- numerous payments related to insurance for the current period are systematically made directly through equity instead of being properly accrued and expensed through the income statement as operating expense for the current period.

We concluded from the records reviewed that many Marine Corps equity transactions either did not meet the qualification for inclusion in the equity account or did not have the proper approval and support as required by GAAP.

The majority of the equity transactions should not have been treated as equity transactions, so we referred them to the Marine Corps Non-Appropriated Fund Audit Services for its review.



## **Agreed-Upon Procedures, Auditor's Actions, and Results**

The Policy Office and the DoD OIG agreed that the auditors would perform procedures to review the financial reporting practices for NAFI. Specifically, we reviewed four primary areas:

- DoD policies,
- accounting for CIP,
- eliminating entry transactions between headquarters and installations or regions and between headquarters funds, and
- prior-period adjustments.

This section contains the agreed-upon procedures, the auditor actions, and the results of accomplishing those procedures as of August 4, 2006.

### **Accounting Policy Review**

#### **Procedure**

We reviewed DoD policies to determine whether policy changes would improve clarity and assist the NAFIs in uniformly applying GAAP.

#### **Auditor Action**

We held discussions with the Policy Office and Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer (OUSD[C]/CFO) to identify their specific needs for the NAFI Reports. We obtained electronic copies of all of the Reports submitted to the Policy Office from FYs 2003 through 2005 for the six Program Groups. We obtained copies of the comments from the Policy Office to the Military Services documenting data integrity problems in the annual reports submitted to them, and discussed them with the Policy Office to establish consistent problems and their possible causes.

We visited the offices of the Military Services responsible for the Reports to gain an understanding of their financial management system and reporting processes, and to document possible causes for the continuing data integrity problems raised by the Policy Office. After our initial review of the Military Services' supporting information for the Reports, we met with the Policy Office and OUSD(C)/CFO to discuss our initial findings. We believe that current policy is the cause for some of the consistent errors made by the Military Services. We then reviewed existing DoD policy and suggested changes to assist the Policy Office and OUSD(C)/CFO in improving clarity within DoD policies so that the NAFIs would uniformly apply GAAP. The suggested policy changes could lead to unqualified opinions on the component-level, consolidated reports for each Program Group submitted to the Policy Office as directed by DoD Instruction 1015.15.

#### **Results**

Appendix D contains suggested changes to DoD regulations, directives, and instructions. Appendix E has the suggested changes for DoD 7000.14, "Financial Management Regulations (FMR)," volume 13.

## **Construction-in-Progress**

### **Procedure**

We reviewed the financial management practices and policies that the Military Services used to account for CIP.

### **Auditor Action**

We interviewed the Military Services personnel responsible for accumulating and consolidating financial information used in the Reports. To understand the methodology used to account for CIP and to verify the existence of GLACs for CIP within the financial statements of the Military Services NAFIs, we requested the following documentation:

- accounting policies and procedures for CIP, and
- standard accounting journal entries for CIP.

We reviewed the FASAB guidance, Financial Accounting Standards Board Pronouncements, DoD FMR, volume 13, with respect to CIP. We compared the Military Services' CIP accounting policies and procedures to the FASAB requirements and related DoD FMR allowable accounting practices.

### **Results**

#### **Army**

We concluded that the Army's accounting treatment for CIP did not comply with the relevant guidance. The Army agreed to change its policy and make an adjusting entry for active construction projects that were expensed. We therefore concluded that the new accounting methodology proposed by Army for CIP was in accordance with the relevant guidance, except for the capitalization of interest expense. The omission of interest expense understates the CIP account balance.

#### **Navy**

We concluded that the Navy accounting guidance for CIP complied with the relevant guidance, except for capitalization of interest and labor costs for NAFI employees. Specifically, the Navy does not include the labor cost of NAFI employees working on a fixed asset if the employees would have been on the payroll regardless of whether they worked on a fixed asset.

#### **Air Force**

We concluded that the Air Force accounting policies for CIP complied with the relevant guidance, except for capitalization of interest.

#### **Marine Corps**

We concluded that the Marine Corps' accounting policies and procedures for CIP complied with the relevant guidance, except for capitalization of interest and asset capitalization thresholds.

## **Eliminating Entry Transactions**

### **Procedure**

Evaluate the process that the Military Services used to account for:

- transactions between headquarters and installations or regions to determine that they are consistent and able to be properly eliminated during consolidation, and
- transactions between headquarters funds so that they may either be properly eliminated during consolidation, if within the same Program Group, or disclosed if they are not within the same Program Group.

### **Auditor Action**

The Policy Office informed us that during its FY 2004 review of the NAFI statements, errors were disclosed indicating a continuing deficiency in procedures for intra-Program Group adjustments required for consolidated reporting. Of particular concern are unreconcilable equity transfers (transactions) between headquarters and field activities. We forwarded to each of the Military Services a list of preliminary questions covering these transfers and requested copies of their consolidation procedures.

From each of the Military Services, we requested and reviewed all eliminating or reclassifying and adjusting journal entries that were part of each consolidation. In addition, we specifically requested documentation from the Military Services for FY 2003, FY 2004, and FY 2005 financial statement transactions that included:

- transactions greater than \$50,000 between headquarters and installations or regions to determine that these transactions were consistent and properly eliminated during consolidation, and
- transactions greater than \$50,000 between headquarters funds, and verification that these transactions were either properly eliminated during consolidation, if within the same Program Group, or disclosed if they were not within the same Program Group.

For each of the Military Services, we requested copies of all audit reports issued by Independent Public Accounting firms for work performed on these Program Groups and related statement of work (SOW) and correspondence between the Policy Office and the Military Services that are relevant to these Program Group Reports.

We focused on the data integrity and compliance problems within the FY 2005 Reports. In addition, we reviewed the supporting information for the FYs 2003 and 2004 Reports to establish potential systemic problems within the Military Services that are responsible for those continuing data integrity problems.

### **Results**

The Army could not provide the appropriate supporting documentation for eliminating entry transactions. Therefore, we could not comment on the

reasonableness of the related elimination entry transactions for these Reports. We were able to review the adjusting, elimination, and reclassification journal entries for FY 2005 for the other Military Services. Based on that analysis, we concluded:

- transactions between headquarters and installations or regions were consistent and properly eliminated during consolidation, and
- transactions between headquarters funds were either properly eliminated during consolidation, if within the same Program Group, or disclosed as footnotes if not within the same Program Group.

We did note the following problems with eliminating entries:

- the Air Force Civilian MWR Program Group financial statements did not eliminate the Air Force Assessment<sup>14</sup> in FYs 2004 and 2005, and
- the Air Force consolidated balance sheet for the Special Purpose Program Group in the SAFIS system reflects a balance of \$545,266 in an account designated as “Receivables from other NAFIs,” but does not reflect this amount in the FYs 2004 and 2005 Reports to the Policy Office, and
- we noted an unusual amount of journal entries at the Marine Corps indicating a failure to accrue activity during the current period. This is indicative of an activity using a modified cash basis method of accounting, which does not comply with GAAP.

## **Prior Period Adjustments**

### **Procedure**

We reviewed prior-period adjustments to determine whether the adjustments were material and whether the purpose of the footnotes was fully disclosed.

### **Auditor Action**

We interviewed the responsible officials at the respective Military Installations, obtained standard operating procedures for equity adjustments, and requested a list of all the Program Groups prior-period adjustments that were greater than \$50,000 for FYs 2003 through 2005.

We then compared the equity transaction information provided by the Military Services to the DoD guidance for allowable equity transactions. DoD Instruction 1015.15 paragraph 5.4.2.4 sets forth this requirement.

Transfers into and out of equity shall be limited to net income, net losses, prior year material corrections, entries associated with establishment, disestablishment, or consolidation of NAFIs, unrealized gains or losses on DoD Component or Military Service Headquarters

---

<sup>14</sup>Assessments are charges between headquarters and field operations, where headquarters records revenues for services levied to the field, while the field records an expense. Failure to eliminate this activity overstates revenues and expenses.

investments, and the distribution and receipt of capital. Distribution of funds from Base Realignment And Closure (BRAC) Reserve Accounts shall be recorded as equity transactions.

In addition, we reviewed equity transactions between headquarters and installations or regions and transactions between headquarters funds to determine that they were consistent and in compliance with DoD Instruction 1015.15.

## **Results**

We noted that in some cases the Military Services properly disclosed material adjustments within the Reports submitted to the Policy Office, but our overall assessment is that all of the Military Services are distorting their income statements by charging current year operating expenses to equity. In addition, the Military Services did not comply with DoD Instruction 1015.15, paragraph 5.4.2.4, which establishes allowable equity transactions or transfers. Finally, the Army's reclassification of equity transfers as program expenses is an incorrect accounting treatment that significantly distorts the income statement and is not in accordance with GAAP.

### **Army**

An Army official's response noted that the Army disclosed all of its prior-period adjustments in the annual Reports. In addition, the same Army official noted that they did not track and could not provide documentation for numerous equity transactions.

### **Navy**

The auditors noticed material discrepancies between the total of equity adjustments provided by the Navy to the DoD OIG and those amounts disclosed in the related Report. The Navy also did not provide adequate descriptions for each of these equity adjustments. Therefore, we were unable to establish whether all prior-period adjustments complied with DoD Instruction 1015.15.

### **Air Force**

We reviewed the list of prior-period adjustments that the Air Force provided and traced their disclosure to the appropriate Report, without exception. Air Force officials stated that they had not disclosed numerous equity transactions below our threshold, and therefore the Air Force probably does not comply with DoD Instruction 1015.15.

### **Marine Corps**

Many of the Marine Corps equity transactions either did not qualify as equity, as defined by DoD Instruction 1015.15, paragraph 5.4.2.4, or did not have the proper approval and support as required by GAAP. Many of the transactions recorded as equity should not have been treated as equity transactions, and we advised Marine Corps Nonappropriated Fund Audit Services of this finding. For further discussion, see Appendix C, "Other Matters of Interest."

## Appendix A. Scope and Methodology

The Policy Office requested that the DoD OIG review the financial reporting practices for Nonappropriated Fund Instrumentalities and Related Activities. The Policy Office desires Military Service-level consolidated financial statements for each of the six Program Groups (defined by DoD Instruction 1015.14, paragraph 4.3). DoD Instruction 1015.15 requires the Military Departments to submit annual financial reports to the Policy Office. During its review of the FY 2004 Reports, the Policy Office noted a continuing deficiency in procedures for intra-Program Group adjustments required for consolidated reporting. Of particular concern were unreconcilable equity transfers between headquarters and field activities, noncompliance with DoD accounting policy for NAFI CIP, and prior-period adjustments.

The Policy Office and DoD OIG discussed and agreed on procedures for the engagement. The procedures included reviewing DoD policies to improve clarity and to determine that NAFIs uniformly apply GAAP, which could lead to unqualified opinions on the component-level consolidated reports for each Program Group submitted to the Policy Office. Specific procedures were to review:

- accounting for CIP,
- transactions between headquarters and installations or regions to determine that they are consistent, so they may be properly eliminated during consolidation,
- transactions between headquarters funds so that they may either be properly eliminated during consolidation, if within the same Program Group, or disclosed if they are not within the same Program Group, and
- prior-period adjustments to determine whether they are material and whether footnotes fully disclose what they are for and why.

The DoD OIG performed these agreed-upon procedures from March 2006 through August 2006 in accordance with GAGAS and attestation standards established by the American Institute of Certified Public Accountants as of January 19, 2006.

**Scope Limitations.** The agreement limited our scope to procedures that did not include tests of management controls. Therefore, we limited our scope to the Military Services covering their financial reporting practices for NAFI and Related Activities, and we judgmentally selected financial information to evaluate the effectiveness and integrity of information flowing into the related financial reports. During the program and methodology reviews, we identified process deficiencies relating to DoD policies in Appendices D and E. We discussed the process deficiencies relating to CIP accounting, eliminating entry transactions between headquarters and installations or regions and between headquarters funds, and prior-period adjustments in the Results section of this report. Finally, we noted other process deficiencies in Appendix C, “Other Matters of Interest.”

**Use of Computer-Processed Data.** We relied on computer-processed data provided by the Policy Office and the four Military Services. We extracted the data from numerous DoD financial systems. We used the computer-processed data to analyze the integrity of the information supporting data included in the annual Reports. We did not determine the reliability of the computer-processed data.

**Government Accountability Office High-Risk Area.** The Government Accountability Office has identified several high-risk areas in DoD. Our audit provides coverage of the two principal high-risk areas within DoD Approach to Business Transformation, (1) DoD Business Systems Modernization, and (2) Defense Financial Management.

## **Appendix B. Prior Coverage**

During the last 12 years, the Government Accountability Office, the DoD Inspector General, the U.S. Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency have issued several reports discussing NAFIs. We have included 22 of those reports. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov>. Unrestricted DoD OIG reports can be accessed at <http://www.dodig.mil/audit/reports>.

### **GAO**

Report No. GAO-06-256R, "Pilot Project to Expand Merchandise Sold in Commissary Stores Will Likely Have Negligible Impact on the Exchange Dividend," December 22, 2005

Report No. GAO-04-56, "DOD Needs to Strengthen Internal Controls over Funds Used to Support USO Activities," December 5, 2003

### **Army**

U.S. Army Audit Agency Report No. A-2006-141-FFH, "Financial Management Structure for the Army Morale, Welfare, and Recreation Program for U.S. Army Installation Management Agency," June 22, 2006

U.S. Army Audit Agency Report No. A-2006-0101-FFH, "Attestation Review of Morale, Welfare, and Recreation Financial Statements-Army Morale, Welfare, and Recreation Fund for U.S. Army Community and Family Support Center," April 27, 2006

U.S. Army Audit Agency Report No. A-2006-0100-FFH, "Attestation Review of Morale, Welfare, and Recreation Financial Statements-Hospitality Cash Management Fund for U.S. Army Community and Family Support Center," April 27, 2006

U.S. Army Audit Agency Report No. A-2006-0019-ALE, "Follow-up Audit of Laundry and Dry Cleaning Services for U.S. Army Installation Management Agency, Europe Region," December 2, 2005

U.S. Army Audit Agency Report No. A-2006-0017-ALE, "Army Golf Operations in Europe for U.S. Army Installation Management Agency, Europe Region," November 10, 2005

U.S. Army Audit Agency Report No. A-2005-0316-ALE, "Follow-up Audit of Nonappropriated Fund Payroll for U.S. Army Installation Management Agency, Europe Region," September 22, 2005



U.S. Army Audit Agency Report No. A-2005-0268-FFP, "Audit of Nonappropriated Fund Financial Management Structure, Installation Management Agency," September 1, 2005

U.S. Army Audit Agency Report No. A-2005-0236-FFH, "Attestation Review of Morale, Welfare, and Recreation Financial Statements-Army Nonappropriated Fund Employee Retirement and 401(k) Savings Plans for U.S. Army Community and Family Support Center," July 18, 2005

U.S. Army Audit Agency Report No. A-2005-0220-ALE, "Follow-up Audit of Controls Over Morale, Welfare, and Recreation Equipment Downrange (Bosnia and Kosovo) for U.S. Army, Europe and Seventh Army," July 14, 2005

U.S. Army Audit Agency Report No. A-2005-0001-FFG, "Secretary of Defense Executive Dining Facility Fund Internal Controls for Office of the Secretary of Defense," July 8, 2005

U.S. Army Audit Agency Report No. A-2005-0080-FFG, "Office of the Secretary of Defense/Joint Staff Welfare and Recreation Association Fund Internal Controls," April 13, 2005

U.S. Army Audit Agency Report No. A-2005-0144-FFH, "Attestation Review of Morale, Welfare, and Recreation Financial Statements-Armed Forces Recreation Centers, U.S. Army Community and Family Support Center," March 23, 2005

U.S. Army Audit Agency Report No. A-2005-0096-FFH, "Army Lodging Overhead Costs for U.S. Army Community and Family Support Center," January 20, 2005

## **Navy**

Naval Audit Service Report No. N2003-0063, "Civilianizing the Marine Corps Nonappropriated Fund Audit Service," July 23, 2003

Naval Audit Service Report No. N2002-0059, "Quality Assurance Review of the Local Audit Function at the Navy Exchange Service Command," July 1, 2002

Naval Audit Service Report No. N2002-0055, "Insufficient Appropriated Fund Support of Morale, Welfare, and Recreation Increases Cost to Individual Marines," June 14, 2002

## **Air Force**

Air Force Audit Agency Report No. F2005-0007-FD2000, "Air Force Morale, Welfare, and Recreation Advisory Board Corporate Governance," September 8, 2005

Air Force Audit Agency Report No. F2004-0002-FD2000, U.S. Army Audit Agency Report No. A-2004-0076-IMH, "Controls Over the Army and Air Force Exchange Service," December 19, 2003

Air Force Audit Agency Report No. F2003-0001-FD2000, U.S. Army Audit Agency Report No. A-2003-314-IMH, "Controls Over the Army and Air Force Exchange Service-Cash Discounts," June 10, 2003

Air Force Audit Agency Report No. F2003-0003-FB4000, "Nonappropriated Fund Cash Controls," December 30, 2002

# **Appendix C. Other Matters of Interest**

## **Accounting Systems**

### **Army**

The Army does not have an enterprise management system in place. The U.S. Army Audit Agency<sup>15</sup> noted in a recent report,

The current fund structure is segmented and complex, requiring many transactions among multiple funds. The funds were aligned geographically, by command, or through assigned functions. The financial reporting and management of multiple funds creates unnecessary—and avoidable—work and complexities.

We concluded that the lack of an integrated system was a contributing factor to the Army's inability to respond to our requests for information and also cause for the numerous interfund transactions that create data integrity problems with the annual consolidated Program Group Reports. In addition, the Army does not have a report writer system and generates the annual Reports manually.

### **Navy**

The primary accounting system, RAMCAS, functions as a centralized integrated accounting system for the Navy Military MWR, Civilian MWR, TDY Lodging, and Military Treatment Facility Lodging Program. The system does not have a report writer, thus CNIC has to consolidate the Program Group numbers manually. As noted earlier in this report, CNIC did not retain copies of the Navy's manually generated, consolidated Program Group documentation. A report writer could have standardized the report function and provided an audit trail for the Reports.

### **Air Force**

The Air Force integrated financial management system SAFIS creates the Air Force annual Reports through a report writer, which minimizes errors and standardizes the reporting process. We did note one error in the Report caused in part by the report writer. Each time the Air Force adds a GLAC to the Air Force accounting system, the Air Force must add the GLAC manually into the report writer. Air Force advised us that their new accounting system will alleviate this problem.

### **Marine Corps**

The Marine Corps financial management system is the AXS-One Accounting System that accounts for the financial information in Program Groups I, II, and V. Financial information for Program Group III is tracked on Excel spreadsheets and entered manually into the AXS-One Accounting System. While the AXS-One

---

<sup>15</sup>U.S. Army Audit Agency Report No. A-2006-141-FFH, "Financial Management Structure for the Army Morale, Welfare, and Recreation Program for U.S. Army Installation Management Agency," June 22, 2006.

Accounting System is the integrated financial system for the Marine Corps, it lacks a report writer, and requires manual preparation of the annual consolidated Program Group reports.

## **Audit Opinions**

We noted inconsistent report formats during our review of approximately 125 audit reports issued by Independent Public Accounting firms. The firms worked on various Military Service Program Group financial statements. Although some audit reports are based on accounting principles generally accepted in the United States, others are based on a comprehensive accounting basis other than GAAP or in accordance with the Military Service internal policies, such as “MCO P1700.27A, MCCS Policy Manual.” Having identified different bases of accounting in these report formats, we requested copies of the Independent Public Accounting SOW from each of the Military Services. We found that the SOWs differ from one Military Service to another, and even from one consolidated Program Group to another within the same Military Service. The Policy Office wants NAFIs to apply GAAP uniformly across Component-level consolidated financial statements for each Program Group. Based on our observations, we concluded that the SOWs were not consistent with the requirement of the Policy Office to obtain audit reports that comply with GAAP. In addition, some of the reports did not state that the audits were conducted in accordance with GAGAS as required by DoD Instruction 7006.6, “Audit of Nonappropriated Fund Instrumentalities and Related Activities,” January 16, 2004.

While the Government Auditing Standards, paragraph 2.05, allows audit reports to provide assurance that financial statements are presented either in compliance with the accounting principles generally accepted in the United States, or with a comprehensive accounting basis other than GAAP, it is our understanding that the Policy Office requires all audits of consolidated Program Groups to be based on GAAP. We suggested that DoD Instruction 1015.15, paragraph 6.5.2., should include the following sentence, “The reports shall be based on or be the basis of annual financial statements presented in conformity with the accounting principles generally accepted in the United States.”

## **Data Integrity**

### **Army**

The Army attempts to eliminate all transactions between Program Groups by manually adjusting the numbers, rather than booking the adjustments through the DFAS. The Army could not support the flow of information from the lowest level of accounting up to the Reports.

We could not establish whether the Army had complete information because it did not have consolidated financial statements. We had to create the consolidated spreadsheets ourselves to help in reconciling the CFSC accounting records to the Army Reports. The Army provided us with hard copies of account totals for each individual field fund, headquarters fund totals, and eliminating entries (some of which lacked support). The eliminating entries lacked general ledger account codes, so we are not certain whether the entries were properly applied.

The following is a list of some of the data integrity problems associated with the Army's Reports:

- The Army MWR total within the FY 2004 Report differs from the accounting records by \$503,335.
- DFAS reported appropriated fund use in the amounts of \$109,476 and \$438,976 for FYs 2004 and 2003, respectively, for nonexistent Army Civilian MWR NAFIs.<sup>16</sup>
- The Army Program Groups I, IV, and V reported negative net income for FYs 2003, 2004, and 2005.<sup>17</sup>
- The Army Special Purpose total within the Report differs from the CFSC supporting information by \$26,373 for FY 2005.
- We could not reconcile the account totals for the Civilian Welfare Fund to the Report because of insufficient information.

## Navy

We identified reconciliations and other concerns during the Report review. The following examples came to our attention in the Navy's Reports:

- A difference of \$60,000 between the FY 2005 consolidated Balance Sheet accounting information for Military MWR and the Report.
- The Navy did not include the Navy Flying Club within the Military MWR consolidation. This omission caused the balance sheet to be understated by \$319,333, \$354,749, and \$357,060 and Net Income to be overstated by \$11,871, \$35,416, and \$2,311 in FY 2003, 2004, and 2005, respectively.
- The Navy Billeting consolidated accounting information for FYs 2003 and 2004 did not match the information included in the Reports.
- The Supplemental Mission Funds program internal accounting information reported in the balance sheet differs from the Report numbers by \$63,644 and \$78,190 and Net Income by \$13,243 and \$45,401 for FYs 2004 and 2005, respectively.
- The Navy New Sanno Hotel FY 2004 internal accounting information within the Net Income differs from the Report numbers by \$21,065.

---

<sup>16</sup>DFAS records for the Civilian MWR NAFIs in Europe, Korea, and Rock Island document the use of Operation and Management, Army funds in the amounts of \$109,476 and \$438,976 for FY 2004 and FY 2003, respectively. However, Army officials informed us that the Army does not possess Civilian MWR NAFIs in Europe, Korea, and in Rock Island.

<sup>17</sup>DoD Instruction 1015.15, paragraph 5.2.6 states, "Program Group I, II, III, and IV NAFIs at the consolidated Military Service level and individual Program Group V and VI NAFIs shall achieve, as a minimum, a break-even or positive net income sufficient to provide for capital requirements."

## **Air Force**

We identified reconciliations and other concerns during the Report review. The following examples came to our attention in connection with the Air Force's Reports:

- A difference of \$385,193 between the FY 2005 consolidated Income Statement accounting information for Military MWR and the Report.
- A difference of \$72,147 between the FY 2003 consolidated Income Statement accounting information for Civilian MWR and the Report.
- Negative income documented within the Report for Military MWR, Civilian MWR, Supplemental Mission, and Special Purpose for FY 2003, FY 2004, and FY 2005.<sup>18</sup>

## **Marines**

The auditors discovered a difference of \$46,005 between the FY 2004 consolidated balance sheet accounting records of the Marine Corps Exchange and the Report. In addition, we noted minor differences between the FY 2004 Supplemental Mission accounting records and the related Report. We found no problems related to data integrity during the testing of the remaining Marine Corps accounting information.

## **NAFI Population**

As part of our analysis of the Reports provided by each of the Military Services to the Policy Office, we reviewed the integrity of the number of NAFIs that each Military Service was reporting to the Policy Office as part of their Reports. To accomplish this task, we requested a list from each Military Service identifying the NAFIs it was managing as well as copies of the documents supporting their establishment. When we received the population lists from the Military Services, we counted the number of NAFIs in each list, and compared them to the number each Military Service stated that it managed in its Reports to the Policy Office.

## **Army**

The Army did not furnish copies of the supporting documentation for establishing the vast majority of its NAFIs. Consequently, we could not verify whether the Army established its NAFIs in accordance with DoD Instruction 1015.15, and we were also unable to validate the number of NAFIs reported in the Army's Reports. In addition, we noticed the following items:

- NAFIs appeared in the NAFI listing with incorrect names,
- four NAFIs no longer existed, one of which was reporting negative balances in its Army Bank and Investment Fund accounts,

---

<sup>18</sup>DoD Instruction 1015.15, paragraph 5.2.6 states, "Program Group I, II, III, and IV NAFIs at the consolidated Military Service level and individual Program Group V and VI NAFIs shall achieve, as a minimum, a break-even or positive net income sufficient to provide for capital requirements."

- the Army incorrectly categorized two NAFIs as part of the Civilian MWR Program Group, and
- two existing NAFIs were not included in the Army's list.

Those conditions led the auditors to conclude that the Army's list was not accurate, and that it did not meet DoD Instruction 1015.15's requirement for maintaining a current listing of its NAFIs. As a result, we concluded that the Army could not support its existence assertion for its NAFIs, and its Reports were incomplete.

## **Navy**

The Navy could not support the existence assertion for its NAFI Reports. The Navy did not provide supporting documentation for establishing any of its NAFIs, with the exception of the New Sanno Hotel. As a result, we were unable to determine if the Navy had established the majority of its NAFIs in compliance with the DoD Instruction 1015.15. We also found problems with the NAFIs reported in the Navy listing that also affected its assertion.

- The Navy included 14 aircraft carriers in its Report, but only 12 aircraft carriers are in active service.
- The Naval Vessel Register listed a fleet size in active commission of 238 ships. However, the NAFI list provided by CNIC documented 410 ships. We know that at the very least, 48 of these ships no longer appear as active in this registry.
- The Navy's Reports did not include the Flying Club or the Military Sealift Command MWR program.
- We believe that the Navy erroneously classified the NAFIs associated with the Military Sealift Command ships as Military MWR NAFIs instead of Civilian MWR NAFIs, and the Military Sealift Command Exchange NAFI as an Armed Services Exchange.

## **Air Force**

We were unable to determine the exact number of NAFIs that the Air Force managed, because it provided documents that show conflicting numbers of NAFIs. In addition, we concluded that Air Force Instruction 34-201, "Use of Nonappropriated Funds (NAFS)," June 17, 2002, was in conflict with DoD Instruction 1015.15 because it does not require written approvals for establishing all NAFIs. Finally, we concluded that we could not validate the existence of any of the Air Force's NAFIs or the completeness of the Air Force's Reports.

## **Marine Corps**

Except for the Civilian MWR NAFIs, we were unable to reconcile the number of NAFIs reported in the Reports with the number of NAFIs that appear on the Marine Corps listing. In addition, the Marine Corps did not furnish copies of the supporting documentation for establishing any of its NAFIs. Therefore, we were unable to determine if any of the established Marine Corps NAFIs complied with DoD Instruction 1015.15. Furthermore, the lack of supporting documentation for

the Marine Corps NAFIs led us to conclude that we could not validate the existence and completeness assertions for any of the Marine Corps Reports. Finally, the lack of documentation also prevented us from determining if the Marine Corps NAFI listing was current or accurate.

## **Reporting Corrections of Errors and Changes in Accounting Principles**

### **Army**

SFFAS No. 21, “Reporting Corrections of Errors and Changes in Accounting Principles,” states that financial statements must be restated if errors result from mistakes in applying accounting principles. The CFSC decision to change its accounting practices for major construction projects is clearly an example of a change from a non-GAAP to a GAAP accounting principle; in other words, accounting for major construction projects as an expense is a departure from GAAP. For informational purposes, the Army expensed numerous major construction, capital purchases, and minor construction projects during previous years with an estimated average cost of \$100 million per year. Because the CFSC changed policy concerning the accounting of major construction projects, it should restate its prior period financial statements that were included as comparative financial statements with its current financial statements. In addition, DoD Instruction 1015.15, paragraph 5.5.2, provides, “Any material differences discovered subsequent to the submission of the reports shall be immediately reported to the PDUSD(P&R)<sup>19</sup> and the deviation fully disclosed in the accompanying auditor’s statement and footnotes.”

### **Air Force**

We discovered a difference of \$385,000 between the FY 2005 consolidated Income Statement accounting information for Military MWR and the Report. Although Air Force officials were aware of this, they did not restate the Report as required by the DoD Instruction 1015.15.

## **Visibility of Accounting Transactions**

Although the MCCA elimination and reclassification adjustments appear reasonable, the volume of adjustments causes immediate reasons for concern. In addition, there were an unusually large number of prior-period adjusting entries recorded during the reporting period that did not appear reasonable. After discussing each type of adjusting entry with MCCA officials, we determined that management had not established formal procedures and methods for developing an accounting estimate, and that they did not properly use the accrual system as required by GAAP and DoD FMR, volume 13. Management does not always accrue its transactions and waits for the documents related to the transaction in question to arrive before creating an adjusting entry, similar to the cash basis method of accounting. This approach does not comply with GAAP and creates an unusually high number of adjusting entries at the end of the accounting period.

Some of these transactions might follow the Marine Corps internal regulations or represent comprehensive forms of accounting other than GAAP, but they do not

---

<sup>19</sup>DoD instructions use the acronym PDUSD(P&R) as the official acronym for the Policy Office.



meet the needs of the Policy Office for a consistent format to present financial statements. Further, accounting transactions that bypass the income statement and are posted directly to the equity fund lose the necessary transparency to allow proper monitoring and reporting or disclosure. The Marine Corps Significant Accounting Policies' footnote disclosure states,

Activities may record certain transactions, normally recorded under accounting principles generally accepted in the United States of America in the income statement, directly to net worth. MCCA is not required to accrue liabilities for workers' compensation claims; claims are recouped as expense when payment is made.

The Policy Office has two goals: a consistent format for presenting financial statements, and improved Marine Corps reporting and disclosure of NAFI funds. To accomplish these goals, we suggest that the Marine Corps follow GAAP and accrue and record expenses on the income statement for the accounting period incurred, rather than later in the equity fund when the cash is received or payments are actually made.

## Appendix D



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

DEC 8 2006

### MEMORANDUM FOR PRINCIPAL DEPUTY UNDER SECRETARY OF DEFENSE FOR PERSONNEL AND READINESS

SUBJECT: Agreed-Upon Procedures Covering the Financial Reporting Practices for  
Nonappropriated Fund Instrumentalities and Related Activities  
(Project No. D2006-D000FH-0120.000)

The Office of the Principal Deputy Under Secretary of Defense for Personnel and Readiness (PDUSD(P&R)) is responsible for performing an annual review of the Nonappropriated Fund Instrumentality (NAFI) consolidated Program Group financial statements (Reports) forwarded to its office by the Military Services. During the review of the FY 2004 Reports, the PDUSD(P&R) discovered unreconcilable equity transfers between headquarters and field activities; noncompliance with DoD accounting policy for NAFI construction-in-progress; and prior-period adjustments. In consonance with the PDUSD(P&R) goal of achieving an unqualified audit opinion on the NAFI Program Group Reports, PDUSD(P&R) requested that auditors in the DoD Office of the Inspector General (DoD OIG) review the financial reporting practices for NAFIs. The review covered four primary areas: DoD policies, accounting for construction-in-progress, eliminating entry transactions between Military Services' headquarters and installations or regions and between headquarters funds, and prior-period adjustments.

As part of the procedures agreed upon by the PDUSD(P&R) and by the DoD OIG, we reviewed DoD policies, directives, instructions, and regulations that fall under the purview of the PDUSD(P&R) and that affect the financial reporting, financial statements, and financial statement audits of NAFIs. As a result of our review, we are providing suggested changes to the guidance that, if implemented, could improve financial reporting for NAFIs.

Should you have any questions, please contact me or Mr. Joseph A. Guba at 703-325-0433.

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

Attachment:  
As stated

Suggested Changes by the Office of the Inspector General of the Department of Defense to DoD Regulations, Directives, and Instructions Under the Purview of the Office of the Under Secretary of Defense for Personnel and Readiness.

### **Overall Comments**

The Principal Deputy Under Secretary of Defense for Personnel and Readiness (PDUSD(P&R)) is responsible for nonappropriated fund policy and DoD Military Morale, Welfare, and Recreation programs, military exchange services, and other authorized Nonappropriated Fund Instrumentalities and Related Activities (NAFI)s. Further, the PDUSD(P&R) has the responsibility to develop, promulgate, and monitor compliance with policy and other guidance to properly administer NAFIs and manage related NAFI resources. The PDUSD(P&R) performs an annual review of the NAFI consolidated Program Group financial statements (Report(s))<sup>20</sup> forwarded to it by the Military Services. During the review of the FY 2004 Reports,<sup>21</sup> the PDUSD(P&R) discovered unreconcilable equity transfers between headquarters and field activities, noncompliance with DoD accounting policy for NAFI construction-in-progress, and prior period adjustments. Because of the irreconcilable equity transfers, and in response to the President's Management Agenda of establishing a goal of achieving an unqualified audit opinion, the PDUSD(P&R) took the initiative to achieve the same for the NAFI Program Groups<sup>22</sup> under its purview. The PDUSD(P&R) requested that auditors from the DoD Office of Inspector General (OIG) review the financial reporting practices for NAFIs. The review covered four primary areas: DoD policies, accounting for construction-in-progress, eliminating entry transactions between Military Services headquarters and installations or regions and between Military Services' headquarters funds, and prior period adjustments.

As part of the agreed-upon procedures between the PDUSD(P&R) and the DoD OIG, we reviewed DoD regulations, directives, and instructions (Guidance). Specifically, we reviewed the Guidance that affects the financial reporting and the likelihood that DoD NAFIs could obtain an unqualified opinion on the audited financial statement, consolidated by Program Groups, for each Military Service. The following are the auditors' suggested changes to DoD Guidance that could improve financial reporting and assist the Military Services in obtaining unqualified audit opinions on their annual consolidated financial statements by Program Groups. The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published.

Any suggested changes to Guidance that refers to DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

---

<sup>20</sup>The Military Services refer to these Reports as 1015.15 Submissions, so for the purposes of this report we will refer to these documents as Report(s).

<sup>21</sup>DoD Instruction 1015.15, "Procedures for Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources," May 25, 2005, paragraph 5.5.2 states the following: "A consolidated financial and management report shall be prepared annually for each Military Service, and Joint Service NAFI. Each consolidated report shall contain the financial statements and reports specified at enclosure 7. Ten copies of the annual report shall be submitted to the PDUSD(P&R) within 120 days following the close of the Program Group fiscal year. The reports shall be based on or be the basis of annual financial statements that comply with the audit requirements of DoD Instruction 7600.6."

<sup>22</sup>DoD Instruction 1015.14 paragraph 4.3 provides that DoD programs or activities and their supporting NAFIs are classified into one of six Program Groups which are Military Morale, Welfare, and Recreation, Armed Services Exchange Programs, Civilian Military Morale, Welfare, and Recreation, Lodging Program, Supplemental Mission Funds, and Special Purpose Central Funds.

- A. DoD Directive 1015.2, “Military Morale, Welfare, and Recreation (MWR),” June 14, 1995**
- 1.a. **Page 7, References (e).** (e) DoD Directive 1015.1, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities,” August 19, 1981.
  - 1.b. **Recommended Change.** (e) DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” November 22, 2005.<sup>23</sup>
  - 1.c. **Justification.** DoD Directive 1015.14 canceled DoD Directive 1015.1, and in turn, DoD Instruction 1015.14 canceled DoD Directive 1015.14. DoD Directive 1015.2 cites a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of Directive 1015.2, DoD needs to update reference (e) to cite DoD Instruction 1015.14.
  - 2.a. **Page 7, References (f).** (f) DoD Directive 1015.8, “DoD Civilian Employee Morale, Welfare and Recreation (MWR) Activities and Supporting Nonappropriated Fund Instrumentalities (NAFIs),” October 22, 1985.
  - 2.b. **Recommended Change.** (f) DoD Instruction 1015.08, “DoD Civilian Employee Morale, Welfare, and Recreation (MWR) Activities and Supporting Nonappropriated Fund Instrumentalities (NAFI),” December 23, 2005.
  - 2.c. **Justification.** DoD Instruction 1015.08 canceled DoD Directive 1015.8. Therefore, DoD Directive 1015.2 cites a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of Directive 1015.2, DoD needs to update reference (f) to cite DoD Instruction 1015.08.
  - 3.a. **Page 7, References (g).** (g) DoD Directive 1330.9, “Armed Services Exchange Regulations,” December 15, 1986.
  - 3.b. **Recommended Change.** (g) DoD Instruction 1330.09, “Armed Services Exchange Policy,” December 7, 2005.
  - 3.c. **Justification.** DoD Instruction 1330.09 canceled DoD Directive 1330.9. Therefore, DoD Directive 1015.2 cites a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of Directive 1015.2, DoD needs to update reference (g) to cite DoD Instruction 1330.09.
- B. DoD Instruction 1015.08, “DoD Civilian Employee Morale, Welfare, and Recreation (MWR) Activities and Supporting Nonappropriated Fund Instrumentalities (NAFI),” December 23, 2005**
- 1.a. **Page 1, References (d).** (d) DoD Directive 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” July 16, 2003.

---

<sup>23</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to Guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

- 1.b. **Recommended Change.** (d) DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” November 22, 2005.<sup>24</sup>
  - 1.c. **Justification.** DoD Instruction 1015.14, November 22, 2005, canceled DoD Directive 1015.14, July 16, 2003. Therefore, DoD Instruction 1015.08 cites a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of DoD Instruction 1015.08, DoD needs to update reference (d) to cite DoD Instruction 1015.14.
  - 2.a. **Page 5, References (f).** (f) DoD Directive 1330.9, “Armed Services Exchange Policy,” November 27, 2002.
  - 2.b. **Recommended Change.** (f) DoD Instruction 1330.09, “Armed Services Exchange Policy,” December 7, 2005.
  - 2.c. **Justification.** DoD Instruction 1330.09 canceled DoD Directive 1330.9. Therefore, DoD Instruction 1015.08 is using a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of DoD Instruction 1015.08, DoD needs to update reference (f) to cite DoD Instruction 1330.09.
- C. DoD Instruction 1015.10, “Programs for Military Morale, Welfare, and Recreation (MWR),” November 03, 1995**
- 1.a. **Page 1, References (c).** (c) DoD Directive 1015.8, “DoD Civilian Employee Morale, Welfare, and Recreation (MWR) Activities and Supporting Nonappropriated Fund Instrumentalities (NAFIs),” October 22, 1985.
  - 1.b. **Recommended Change.** (c) DoD Instruction 1015.08, “DoD Civilian Employee Morale, Welfare, and Recreation (MWR) Activities and Supporting Nonappropriated Fund Instrumentalities (NAFI),” December 23, 2005.
  - 1.c. **Justification.** DoD Instruction 1015.08 canceled DoD Directive 1015.8. Therefore, DoD Instruction 1015.10 cites a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of DoD Instruction 1015.10, DoD needs to update reference (c) to cite DoD Instruction 1015.08.
  - 2.a. **Page 1, References (d).** (d) DoD Directive 1330.9, “Armed Services Exchange Regulations,” December 15, 1986.
  - 2.b. **Recommended Change.** (d) DoD Instruction 1330.09, “Armed Services Exchange Policy,” December 7, 2005.
  - 2.c. **Justification.** DoD Instruction 1330.09 canceled DoD Directive 1330.9. Therefore, DoD Instruction 1015.10 cites a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of DoD

---

<sup>24</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to Guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

Instruction 1015.10, DoD needs to update reference (d) to cite DoD Instruction 1330.09.

- 3.a. **Page 17, References (e).** (e) DoD Instruction 1015.1, “Establishment, Management and Control of Nonappropriated Funds Instrumentalities,” August 19, 1981.
- 3.b. **Recommended Change.** (e) DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” November 22, 2005.<sup>25</sup>
- 3.c. **Justification.** DoD Instruction 1015.1 does not exist. However, the title of the instruction in reference (e) is similar to the title of DoD Directive 1015.1 and both have the same date. Therefore, it is possible that when DoD Instruction 1015.10 was drafted the word “Instruction” was substituted for “Directive.” If that is the case, to preserve the integrity of this instruction, DoD needs to update reference (e) of this instruction with DoD Instruction 1015.14.
- 4.a. **Page 15, Paragraph 5.2.4.** Fund MWR programs with the proper fund sources. Ensure respective funding’[sic] streams are identified in annual budgts[sic] to meet MWR goals.
- 4.b. **Recommended Change.** Fund MWR programs with the proper fund sources and include a reference that lists the approved types of funds. Identify respective funding streams in annual budgets to assist MWR activities in meeting their goals.
- 4.c. **Justification.** The current version of the instruction includes the typos “budgts” and “funding’”, which should be corrected to improve the readability of Instruction 1015.10. In addition, the instruction should refer to a list of the types of funding that are considered to be “proper fund sources,” and should explain under which circumstances those funds should be used. We based our conclusion on discovering that appropriated funds were treated as an equity adjustment, even though the criteria stated that those types of transactions were not equity adjustments. Finally, the phrase “to meet MWR goals” is vague. By adding the phrase, “to assist MWR activities in meeting their mission,” informs the Heads of DoD Components that using budgets will assist them in meeting the goals for the MWR fund(s) that they are responsible for managing.

**D. DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” November 22, 2005 (currently in coordination)**

When the DoD OIG announced this project, DoD Instruction 1015.14 was up-to-date. However, on June 23, 2006, the PDUSD(P&R) asked the DoD OIG to review and comment on the new DoD Instruction 1015.15. Further, the new DoD Instruction 1015.15 would cancel the existing DoD Instruction 1015.14 and

---

<sup>25</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to Guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

incorporate the contents of the outdated instruction into the new instruction. As a result, the DoD OIG will not provide additional comments on DoD Instruction 1015.14.

**E. DoD Instruction 1015.15, “Procedures for Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” May 25, 2005 (currently in coordination)**

When the DoD OIG announced this project, DoD Instruction 1015.15 was up-to-date. However, in June 23, 2006, the PDUSD(P&R) asked the DoD OIG to review and comment on the new DoD Instruction 1015.15, which cancels DoD Instruction 1015.14 and incorporates the contents of the outdated report instruction into the new DoD Instruction 1015.15. As a result, the DoD OIG will not provide additional comments on the DoD Instruction 1015.15, dated May 25, 2005.

**F. Draft DoD Instruction 1015.15, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” (currently in coordination)**

DoD OIG commented on the new DoD Instruction 1015.15 in July 2006, and did not include any audit findings or information related to this agreed-upon procedures engagement. In addition, the original DoD OIG review of the instruction did not discuss requirements for audits of NAFI Program Groups by Independent Public Accounting firms.

- 1.a. **Page 6, Paragraph 4.9.** The DoD Component or Military Service headquarters’ designee shall maintain management and financial information and submit annual consolidated financial and management reports in accordance with [Enclosure 8](#).
- 1.b. **Recommended Change.** The DoD Component or Military Service headquarters’ designee shall maintain management and financial information and submit annual financial and management reports consolidated by Program Group, as defined in DoD Instruction 1015.14, paragraph 4.3, in accordance with [Enclosure 8](#).
- 1.c. **Justification.** When we planned our agreed-upon procedures engagement, the PDUSD(P&R) stated that its goal was to obtain unqualified audit opinions on the consolidated financial statements by Program Group for each of the Military Services. If the PDUSD(P&R) is to attain its goal, it needs to clearly state in DoD Instruction 1015.15 that the financial statements and reports for each Military Service must be consolidated by Program Group.
- 2.a. **Page 7, Paragraph 4.14.** The Heads of the DoD Components shall provide for the periodic review and audit of NAFIs to assure continued need for the functions performed and that those needs are being met in accordance with sound business practices.
- 2.b. **Recommended Change.** Add the following sentence at the end of the paragraph: “In addition, audits of the financial statements consolidated by Program Group for each Military Service shall be audited annually.”

- 2.c. **Justification.** Paragraph 4.14 is vague because it does not clearly state how frequently the NAFIs should be reviewed or audited, and it does not distinguish between performance audits and financial statement audits. By adding the suggested sentence, PDUSD(P&R) will have a specific requirement for auditing the financial statements consolidated by Program Group for each Military Service on an annual basis.
- 3.a. **Page 11, Paragraph 6.3.2.** The DoD Component shall determine the format as long as data allows for management analysis of each Funding Category within a Program Group, to provide for budget to actual comparisons to financial statements, and to evaluate performance against program plans.
- 3.b. **Recommended Change.** PDUSD(P&R) should take out the reference to the DoD Components and rewrite this paragraph explaining why the Program Groups' budgets should have a standard DoD format. In addition, the PDUSD(P&R) should include a template for the standard budget format as part of one of its enclosures to this instruction.
- 3.c. **Justification.** The requirement as currently drafted allows each DoD Component to develop its own format for the budget in question. Each DoD Component could present a budget in a different format, and might present a different type of data than the other Components. Therefore, because the purpose of each NAFI Program Group is similar, regardless of DoD Component, the PDUSD(P&R) should develop a standard format for the budgets in question to establish consistency throughout DoD.
- 4.a. **Page 11, Paragraph 6.4.2.** Transactions between NAFIs within a Program Group shall be recorded concurrently and elimination entries made before issuing consolidated financial reports.
- 4.b. **Recommended Change.** Transactions between NAFIs within a Program Group shall be recorded concurrently and elimination entries made before the issuance of consolidated financial reports, by Program Group, for each Military Service.
- 4.c. **Justification.** The intention of PDUSD(P&R) is to attain unqualified audit opinions on the consolidated financial statements by Program Group. Paragraph 6.4.2 should state that each Military Service must consolidate the financial reports by Program Group.
- 5.a. **Page 11, Paragraph 6.4.2.2.** Extraordinary income or expense shall be shown in the financial statements separately from ordinary operations and footnoted.
- 5.b. **Recommended Change.** Extraordinary income or loss shall be shown in the consolidated financial statements by Program Group after revenue and expenses from ordinary operations. In addition, extraordinary income or loss shall be footnoted.
- 5.c. **Justification.** Paragraph 6.4.2.2 is vague because it does not state clearly where in the financial statements the extraordinary items will be reported. As a result, each Military Service can report extraordinary items in a separate part of the financial statements; for example, either above or below ordinary operations.



Appendix D of the Financial Accounting Standards Board (FASB) Interpretation 18, "Accounting for Income Taxes in Interim Periods," March 1977, page 36, shows a sample presentation for an income statement with an extraordinary item.

- 6.a. **Page 12, Paragraph 6.4.2.3.** Follow-on distribution of grants and dividends shall be recorded as "other expense."
- 6.b. **Recommended Change.** The sentence requiring follow-on distributions of grants and dividends to be recorded as "other expense" should be removed from paragraph 6.4.2.3.
- 6.c. **Justification.** The requirement for recording follow-on distributions of grants and dividends as "other expense" makes it possible for the NAFIs to record expenses or revenues twice, depending on the NAFI needs at the time of the transaction. Recording follow-on distributions of grants and dividends as "other expenses" makes it difficult to track the transactions. As a result, the records of the entity are not clear, preventing management and independent auditors from understanding the nature of the transactions. Furthermore, during the performance of our agreed-upon procedures, we discovered that at least two different Military Services were treating transfers of funds within a Program Group as grant expenses. The first Military Service was treating major construction projects at the headquarters level as a grant expense, and once the asset was completed, the Military Service would transfer it to the installation. The second Military Service transferred funds from its headquarters fund to its installations to purchase equipment. The Military Service recorded this transfer as a grant expense. However, in the auditors' opinion, both of those transfers should have been treated as equity transactions between the headquarters funds and the installation funds, as required by the DoD 7000.14, "Financial Management Regulation (FMR), volume 13, chapter 3, Assets," August 1994. Moreover, during the consolidation of each Program Group, the equity transactions for major construction and equipment transfers between headquarters and the installations should have been eliminated. In our opinion, eliminating the previously discussed sentence in paragraph 6.4.2.3 would assist PDUSD(P&R) in preventing the Military Services from improperly recording nonmonetary (fixed assets) transfers between NAFIs as grant expenses.
- 7.a. **Page 12, Paragraph 6.4.2.6.** Tangible fixed assets, except construction in progress, shall be depreciated over their expected useful lives. Depreciation and amortization shall be established and reported on financial statements. The DoD Components shall utilize the straight-line method of depreciation and prescribe the useful lives of assets and disclose them in the notes to the financial statements.
- 7.b. **Recommended Change.** The PDUSD(P&R) should coordinate with the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer (OUSD[C]/CFO) to develop a standard schedule of useful lives for fixed assets that the DoD NAFIs own. Ideally, the schedule should mirror the one presented in Table 6-7 of DoD FMR, volume 4, chapter 6, "Property, Plant, and Equipment," July 2006, to maintain consistency throughout DoD. We also suggest that the schedule for useful lives be included in DoD FMR, volume 13, chapter 3, "Assets," August 1994, and DoD Instruction 1015.15.
- 7.c. **Justification.** Because the OUSD(C)/CFO is responsible for promulgating DoD accounting policy, the PDUSD(P&R) should coordinate the development of a

schedule for useful lives with OUSD(C)/CFO. It should be noted that allowing each NAFI or Military Service to develop its own estimated standard for useful lives will prevent DoD managers from comparing the financial statements published by each Program Group and by each Military Service. Furthermore, to maintain uniformity among the NAFIs and across DoD, the useful lives schedule should mirror the one that is already in Table 6-7 of DoD FMR, volume 4, chapter 6.

- 8.a. **Page 12, Paragraph 6.4.2.6.1.** The Armed Services Exchanges shall: Assign an expected useful life within the following parameters:
- 8.b. **Recommended Change.** As previously stated, the PDUSD(P&R) should coordinate with OUSD(C)/CFO to develop a standard schedule of useful lives for all of the NAFIs to follow. Therefore, section 6.4.2.6.1 should be substituted with uniform depreciation requirements for all NAFIs and not just for the Armed Services Exchanges. Finally, the previously addressed depreciation requirements should be included in both this section of DoD Instruction 1015.15 and in DoD FMR, volume 13, chapter 3.
- 8.c. **Justification.** The product of this coordinated effort should be a uniform depreciation schedule for NAFIs that should be published in both DoD Instruction 1015.15 and in DoD FMR, volume 13, chapter 3. Additionally, the uniform depreciation schedule should mirror the one published in Table 6-7 of DoD FMR, volume 4, chapter 6. Implementing this suggestion will allow DoD Managers to compare the financial information that the NAFIs publish, but they will also be able to compare it with other revenue-producing entities within DoD.
- 9.a. **Page 13, Paragraph 6.4.2.6.1.2.** Salvage value shall not be computed on real property assets.
- 9.b. **Recommended Change.** Paragraph 6.4.2.6.1.2 should read, “For purposes of computing depreciation, real property assets do not have salvage value.” In addition, the PDUSD(P&R) should coordinate the requirement in paragraph 6.4.2.6.1.2 with OUSD((C)/CFO), and included in DoD FMR, volume 13, chapter 3, to prevent conflicts between the two publications.
- 9.c. **Justification.** The requirement implies that the entity will be unable to earn salvage value from the disposal of real property assets. The suggested change clearly states that for purposes of computing depreciation, real property assets will not have a salvage value. In addition, the recommended change is an excerpt from DoD FMR, volume 4, chapter 6; thus it provides uniform accounting policy for salvage values across DoD.
- 10.a. **Page 13, Paragraph 6.4.2.8.** The DoD Components shall jointly establish and maintain a uniform chart of accounts and common financial reporting procedures in accordance with [Reference \(z\)](#). The chart of accounts and common financial reporting procedures shall be updated annually and submitted to the PDUSD(P&R) by October 1 of each year.
- 10.b. **Recommended Change.** Paragraph 6.4.2.8 should include a reference to the uniform chart of accounts. Furthermore, PDUSD(P&R) should coordinate with OUSD(C)/CFO to develop a uniform chart of accounts for all of the NAFIs that either uses the uniform chart of accounts as a basis for the exchanges or a hybrid of the U.S. Standard General Ledger (USSGL).

- 10.c. **Justification.** Including a reference to the document that publishes the uniform chart of accounts or including it as an enclosure to this instruction will make it easier for the intended users of this instruction to access the chart of accounts. In addition, to achieve comparability and consistency among the DoD NAFIs, they should use the same uniform chart of accounts. Basing the new uniform chart of accounts on the one that the Armed Services Exchanges use or developing a hybrid based on the USSGL will ease the transition from multiple charts of accounts to a single uniform chart of accounts for all NAFIs.
- 11.a. **Page 14, Paragraph 6.5.2.** A consolidated financial and management report shall be prepared annually for each Military Service and Joint Service NAFL. Each consolidated report shall contain the financial statements and reports specified at [Enclosure 8](#). The report shall be submitted in the specified software and media to the PDUSD(P&R) within 120 days following the close of the Program Group fiscal year. The reports shall be based on or be the basis of annual financial statements that comply with the audit requirements of [Reference \(ac\)](#). Any material differences discovered subsequent to the submission of the reports shall be immediately reported to the PDUSD(P&R) and the deviation fully disclosed in the accompanying auditor's statement and footnotes.
- 11.b. **Recommended Change.** A consolidated financial and management report shall be prepared annually, by Program Group, for each Military Service and Joint Service NAFL. Each report that is consolidated by Program Group shall contain the financial statements and reports specified at [Enclosure 8](#). The report shall be submitted in the specified software and media to the PDUSD(P&R) within 120 days following the close of the Program Group's fiscal year. The report shall be based on the consolidated audited financial statements by Program Group issued by each Military Service. Any material differences after the reports are submitted shall be immediately reported to the PDUSD(P&R) and fully disclosed in the accompanying auditor's statement and footnotes.
- 11.c. **Justification.** We understand that the PDUSD(P&R) goal is to obtain unqualified audit opinions for the consolidated financial statements of each Program Group for each Military Service. As a result, we provided the previously mentioned suggestion for paragraph 6.5.2. Our suggested changes make clear that the financial statements being discussed in the paragraph are the ones being consolidated for each Program Group for each Military Service and that the annual reports will also be consolidated by Program Group and will use the previously mentioned financial statements as a basis.
- 12.a. **Page 15, Paragraph 6.7.4.2.** A financial statement audit is required annually and a more comprehensive audit to include fund administration and internal controls is required at least biannually.
- 12.b. **Recommended Change.** A consolidated financial statement audit of each Program Group for each Military Service is required annually. As part of the consolidated financial statement audit by Program Group, the auditors shall test the adequacy of internal controls and compliance with laws and regulations. In addition, a more comprehensive audit to include fund administration is required at least biannually.
- 12.c. **Justification.** Government Auditing Standards (Government Accountability Office Yellow Book) require that as part of an opinion or disclaimer on financial statements, the auditors include in their reports on the financial statements either

- a: (1) description of the scope of the auditors' testing of internal controls for financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements and the results of those tests or an opinion, if sufficient work was performed, or (2) reference to the separate report(s) containing that information.
- 13.a. **Page 16, Paragraph 6.7.5.3.** The Armed Services Exchanges shall also include, as part of their annual year-end certified financial audit, an overview report that comments on the financial status of the credit program.
- 13.b. **Recommended Change.** The Armed Services Exchanges shall also include, as part of their annual year-end audited consolidated financial statements (conducted by an Independent Public Accounting [IPA] firm) by Program Group for each Military Service, an overview report that comments on the financial status of the credit program.
- 13.c. **Justification.** The requirement is confusing because it does not clearly state that the financial statements must be audited by an IPA firm. Furthermore, the requirement does not state that the financial statements in question will be consolidated by Program Group for each Military Service. As previously stated, it is our understanding that PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements by Program Group.
- 14.a. **Page 20, Paragraph 6.8.** The DoD Components shall provide for the periodic review and audit of NAFIs, as required in [Reference \(ac\)](#) and DoD Directive 7600.2 (Reference (br)).
- 14.b. **Recommended Change.** DoD Components shall provide for the annual audit of financial statements by an IPA firm. In the case of reviews and audits that are not related to financial statements, the DoD Components shall provide for the periodic review and audit of NAFIs. All reviews and audits of NAFIs shall be performed in accordance with [Reference \(ac\)](#) and DoD Directive 7600.2 (Reference (br)).
- 14.c. **Justification.** Paragraph 6.8 does not distinguish between financial statement audits and performance audits. Furthermore, financial statement audits should be performed on an annual basis. However, for nonfinancial audits and reviews the PDUSD(P&R) should determine how frequently these type of engagements should be performed and the subjects that should be reviewed.
- 15.a. **Page 20, Paragraph 6.8.2.** Each Military Service shall require an annual Service-wide audit of its NAFIs by an independent audit organization. These audits shall include the Headquarters NAFIs and such intermediate-level and individual NAFIs as may be necessary for the auditors to express an opinion on the NAFI financial statements of the Military Services. Audits by certified public accountants shall comply with [Reference \(ac\)](#).
- 15.b. **Recommended Change.** Each Military Service shall require an annual Service-wide audit of the consolidated financial statements of each Program Group, performed by an independent certified public accounting (CPA) firm. These audits shall include the Headquarters NAFIs and such intermediate-level and individual NAFIs as may be necessary for the auditors to express an opinion on the NAFI consolidated financial statements of each Program Group for the

Military Services. The previously described audits shall comply with [Reference \(ac\)](#).

- 15.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements of each Program Group. The PDUSD(P&R) also wants the audits in question to be performed by an independent CPA firm and all NAFI audits performed in accordance with [Reference \(ac\)](#).
- 16.a. **Page 21, Paragraph 7.1.** The annual consolidated financial and management report required by [subparagraph 5.5.2](#), has been assigned Report Control Symbol DD-P&R(A)1344 in accordance with DoD 8910.1-M ([Reference \(bt\)](#)).
- 16.b. **Recommended Change.** The annual consolidated financial and management report of each Program Group for each Military Service required by [subparagraph 6.5.2](#), has been assigned Report Control Symbol DD-P&R(A) 1344 in accordance with DoD 8910.1-M ([Reference \(bt\)](#)).
- 16.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain an unqualified audit opinion on the consolidated financial statements of each Program Group. The reports in question must be based on the consolidated financial statements of each Program Group for each Military Service. Furthermore, DoD Instruction 1015.15 does not have a paragraph numbered 5.5.2. However, paragraph 6.5.2 does require each Military Service and Joint Service NAFI to preparation prepare an annual consolidated financial report.
- 17.a. **Page 21, Paragraph 7.2.** The annual treasury management report required by [subparagraph 5.7.4.1](#), is exempt from licensing in accordance with paragraph C4.4.6. of [Reference \(bt\)](#).
- 17.b. **Recommended Change.** The annual treasury management report required by [subparagraph 6.7.4.1](#), is exempt from licensing in accordance with paragraph C4.4.6.of [Reference \(bt\)](#).
- 17.c. **Justification.** DoD Instruction 1015.15 does not have a subparagraph numbered 5.7.4.1. However, subparagraph 6.7.4.1 requires the nonappropriated fund treasury managers of the DoD Component Headquarters to present the results of their most recent “Annual NAF Treasury Management Report” at an annual meeting with representatives from the offices of PDUSD(P&R) and OUSD(C)/CFO. In addition, contrary to the statement in paragraph 7.2, subparagraph 6.7.4.1 only requires an annual meeting between representatives from PDUSD(P&R), OUSD(C)/CFO and the DoD Components to discuss the most recent annual treasury management report, but makes no reference to the requirement of preparing a report. Therefore, we suggest that PDUSD(P&R) either modify paragraph 7.2 to reflect the information presented in subparagraph 6.7.4.1 or add a requirement for the preparation of an annual treasury management report in subparagraph 6.7.4.1.
- 18.a. **Page 56, Paragraph E8.1.1.** The consolidated financial report submitted for each Program Group shall include:
- 18.b. **Recommended Change.** The consolidated financial report submitted for each Program Group for each Military Service shall include:

- 18.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements for each Program Group. In addition, the reports in question should be based on the consolidated financial statements for each Program Group for each Military Service.
- 19.a. **Page 56, Paragraph E8.1.2.2.3.** The annual Sales, Profits, and Dividends Report shall be submitted with preliminary figures by February 15 of each year and the final report submitted with the consolidated financial report (E8.A8.).
- 19.b. **Recommended Change.** The annual Sales, Profits, and Dividends Report shall be submitted with preliminary figures by February 15 of each year and the final report submitted with the consolidated financial report of each Program Group for each Military Service.
- 19.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements for each Program Group. The reports in question should be based on the consolidated financial statements of each Program Group for each Military Service.
- 20.a. **Page 57, Paragraph E8.1.3.** The annual report shall include a narrative for each Program Group to ensure clarity in the data reported and to highlight significant operations and trends. The narrative shall meet standards of full disclosure.
- 20.b. **Recommended Change.** The annual report consolidated for each Program Group of each Military Service shall include a clear narrative discussing the data reported and highlighting significant operations and trends. The narrative shall meet standards of full disclosure.
- 20.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements of each Program Group. The reports in question should be based on the consolidated financial statements of each Program Group for each Military Service.
- 21.a. **Page 57, Paragraph E8.1.4.** Each Program Group shall provide notes to the financial statements in accordance with the managerial accounting practices at [subparagraph 5.4.2.](#) of this Instruction.
- 21.b. **Recommended Change.** Each Military Service shall provide notes on the consolidated financial statements of each Program Group in accordance with the managerial accounting practices at [subparagraph 6.4.2.](#) of this Instruction.
- 21.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements of each Program Group. In addition, this instruction does not have a paragraph numbered 5.4.2; however, paragraph 6.4.2 and its subsections do discuss managerial accounting practices for the NAFIs.
- 22.a. **Page 57, Paragraph E8.1.4.1.** Footnotes to the financial statements shall disclose the nature and amount of material transactions between Program Groups.
- 22.b. **Recommended Change.** Footnotes in the consolidated financial statements of each Program Group for each Military Service shall disclose the nature and amount of material transactions between Program Groups. In addition, this



section should include a methodology for determining a materiality threshold or a dollar value that should be used as the materiality threshold; for example, all transactions between Program Groups that exceed \$50,000.

- 22.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements of each Program Group. Furthermore, because DoD Instruction 1015.15 does not define materiality, one of the Military Services informed us that it did not track, or even disclose, transactions between Program Groups. Therefore, to prevent this situation from repeating itself, the PDUSD(P&R) should define what constitutes a material transaction between Program Groups.
- 23.a. **Page 57, Paragraph E8.1.4.3.** The Balance Sheet, Statement of Income and Expense, and Schedule A - APF and NAF Expense Summary Reports shall be footnoted to disclose the amount of DoD MWR USA support, UFM support, or other APF support included in the NAFI financial statements.
- 23.b. **Recommended Change.** The Balance Sheet, Statement of Income and Expense, and Schedule A - APF and NAF Expense Summary Reports shall include a footnote that discloses the amount of DoD MWR USA support, UFM support, or other APF support included in the NAFI consolidated financial statements of each Program Group for each Military Service.
- 23.c. **Justification.** The PDUSD(P&R) wants each Military Service to obtain unqualified audit opinions on the consolidated financial statements of each Program Group.
- 24.a. **Page 77, E9.4.1.2.** When dealing with financial institutions and their insurers, it is imperative that the NAFI be properly established in writing and designated. Complete and current documentation of all those permitted to make withdrawals or otherwise direct actions related to the account shall be provided to the financial institution.
- 24.b. **Recommended Change.** PDUSD(P&R) should define the term “designated.” In addition, this paragraph should include alternative procedures that can be used to validate and support the existence of a NAFI.
- 24.c. **Justification.** The term “designated” should be defined because the sentence is confusing to the reader. Also, during our performance of the agreed-upon procedures, we discovered that the Military Services were either not in possession of or did not provide us with supporting documentation for establishing nearly all of their NAFIs. Therefore, we suggest that PDUSD(P&R) ask the Military Services to validate the existence of its NAFIs and to use alternative processes to document their existence.
- 25.a. **Page 92, Paragraph E9.A.3.** Independent Financial and Compliance Audits Conducted Since Last Report:
- 25.b. **Recommended Change.** The PDUSD(P&R) should define the meaning of the word “independent” and include the word “Statement” after the word “Financial” if the engagement is related to an audit of the financial statements.

- 25.c. **Justification.** The term “independent” is vague. The PDUSD(P&R) should clarify whether it refers to independent financial statement audits performed by an IPA firm or by an entity similar to the DoD OIG.
- 26.a. **Page 100, Paragraph E10.2.4.5.** Documentation to include Financial Accounting Standard 133 and International Swap Dealers Association (ISDA) agreements.
- 26.b. **Recommended Change.** The PDUSD(P&R) and OUSD((C)/CFO) should reach a consensus on the type of accounting standards that the NAFIs are required to follow. In other words, whether the NAFIs are required to follow the pronouncements published by either the Federal Accounting Standards Advisory Board (FASAB) (Federal entities) or the FASB (private sector entities).
- 26.c. **Justification.** The FASAB accounting principles are also considered to be generally accepted accounting principles (GAAP) as defined in American Institute of Certified Public Accountants (AICPA) Codification of Auditing Standards, AU 411.14. Federal entities can rely on AICPA and FASB pronouncements specifically made applicable to federal governmental entities by FASAB Statements or Interpretations. Further, the DoD FMR, volume 13, chapter 1, “Nonappropriated Fund Accounting,” January 2004, section B, “GAAP Hierarchy,” page 1-6, identifies FASB only as being part of the GAAP hierarchy, which may indicate that DoD intended the NAFIs to use FASB accounting principles. The FASAB website states the following in relation to GAAP hierarchy:

The AICPA Council designated FASAB as the body that establishes accounting principles for federal entities. The AICPA’s hierarchy of generally accepted accounting principles in Statement of Auditing Standards (SAS) No. 91, The Federal GAAP Hierarchy, governs what constitutes GAAP for U.S. government reporting entities. The hierarchy lists the priority sequence of sources that an entity should look to for accounting and reporting guidance.

In addition, the FASAB website also includes the Federal hierarchy of GAAP.

**G. DoD Instruction 1330.09, “Armed Services Exchange Policy,” December 7, 2005 (currently in coordination)**

When DoD OIG announced this project, DoD Instruction 1330.09 was up-to-date. However, in August 2006, PDUSD(P&R) informed the auditors that the instruction had been sent to formal coordination. Further, PDUSD(P&R) explained that DoD Instruction 1330.21 was being coordinated and that it would cancel DoD Instruction 1330.09 when DoD Instruction 1330.21 is published.

- 1.a. **Page 8, References and (i).** (i) DoD Directive 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” July 16, 2003.



- 1.b. **Recommended Change.** (i) DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” November 22, 2005.<sup>26</sup>
- 1.c. **Justification.** DoD Instruction 1015.14 canceled DoD Directive 1015.14. Therefore, DoD Instruction 1330.09 is using a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of the instruction, DoD needs to update reference (i) of the instruction with DoD Instruction 1015.14.
- 2.a. **Page 3, Paragraph 4.6.** Methods of Operation. Each Military Department shall organize and operate its exchange system(s) in the most efficient and cost-effective way to meet Service-unique needs, maintain good customer service, ensure competitive pricing, and continue support for military MWR programs, unless prohibited by DoD policy. The Armed Services exchanges shall initiate and maintain best business practices through independent and cooperative efforts to maximize efficiencies, which shall offset operational costs, ensure modernization of facilities, improve patron services, and ensure continued contributions to military MWR programs, unless prohibited by DoD policy.
- 2.b. **Recommended Change.** This section of the regulation should explain the basis for measuring efficiency and cost-effectiveness; in addition, the section should include the benchmarks for efficiency and cost-effectiveness that will be used to measure the performance of the exchanges. Also, this paragraph should define the type of “best business practices” to make this paragraph clearer.
- 2.c. **Justification.** If a basis for determining efficiency and cost-effectiveness is not provided to the Military Services, they will be forced to develop their own basis for measuring efficiency and cost-effectiveness, which may differ from Military Service to Military Service. As a result, the Office of the Secretary of Defense (OSD) will be unable to compare the performance of one Military Service against another and truly manage exchanges in the most efficient and cost-effective manner. In addition, the term “best business practices” is vague and open for interpretation. Therefore, OSD should define the term “best business practices” and identify those in question to allow the Military Services to manage the exchanges in the way the OSD intended.

#### **H. DoD Instruction 1330.21, “Armed Services Exchange Regulations.” July 14, 2005 (currently in coordination)**

When the DoD OIG announced this project, DoD Instruction 1330.21 was current. However, on August 2006, the PDUSD(P&R) informed the auditors that the instruction had been sent for formal coordination.

- 1.a. **Page 1, References and (b).** (b) DoD Directive 1330.9, “Armed Services Exchange Policy,” November 27, 2002.

---

<sup>26</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to Guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

- 1.b **Recommended Change.** (b) DoD Instruction 1330.09, “Armed Services Exchange Policy” December 7, 2005.
- 1.c **Justification.** DoD Instruction 1330.09 canceled DoD Directive 1330.9. Therefore, DoD Instruction 1330.21 is using a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of this instruction, DoD needs to update reference (b) of this instruction with DoD Instruction 1330.09.
- 2.a **Page 1, References and (d).** (d) DoD Directive 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” July 16, 2003.
- 2.b **Recommended Change.** (d) DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources” November 22, 2005.<sup>27</sup>
- 2.c **Justification.** DoD Instruction 1015.14. canceled DoD Directive 1015.14. Therefore, DoD Instruction 1330.21 is using a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of this instruction, DoD needs to update reference (d) with DoD Instruction 1015.14.
- 3.a **Page 8, Reference (ab).** (ab) DoD Audit of Nonappropriated Fund Instrumentalities And Related Activities,” January 16, 2004.
- 3.b **Recommended Change.** (ab) DoD Instruction 7600.6 “DoD Audit of Nonappropriated Fund Instrumentalities And Related Activities,” January 16, 2004.
- 3.c **Justification.** The instruction includes the title of the criteria that it is referencing, but does not state whether it is a regulation, manual, directive, or instruction, and it does not include a number to identify the criteria in question. Based on the title that appears in reference (ab) of DoD Instruction 1330.21, the auditors concluded that the criteria being referenced are in DoD Instruction 7600.6 “DoD Audit of Nonappropriated Fund Instrumentalities And Related Activities,” January 16, 2004.
- 4.a **Enclosure 2.**
- 4.b **Recommended Change.** Enclosure 2 should include the definition of Program Group II - Armed Services Exchanges.
- 4.c **Justification.** DoD Instruction 1015.15 states that “Program Group II - Armed Services Exchanges and Program Group III - Civilian MWR programs are defined in DoD Instruction 1330.21 and DoD Directive 1015.8.” Although DoD Instruction 1330.21 states that terms used in the instruction are defined in Enclosure 2, we were unable to find a definition for either Program Group II or Armed Services Exchanges in Enclosure 2 or in the rest of DoD Instruction 1330.21. As a result, the auditors concluded that the definition of

---

<sup>27</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to Guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

Program Group II - Armed Services Exchanges needs to be included in enclosure 2.

**I. DoD Instruction 4105.71, “Nonappropriated Fund (NAF) Procurement Procedure,” February 26, 2001 (currently in coordination)**

When the DoD OIG announced this project, DoD Instruction 4105.71 was current. However, on August 2006, the PDUSD(P&R) informed us that the instruction was going to be sent out shortly for formal coordination.

- 1.a. **Page 1, References (b).** (b) DoD Directive 1015.1, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities,” August 19, 1981.
- 1.b. **Recommended Change.** (b) DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources” November 22, 2005.<sup>28</sup>
- 1.c. **Justification.** DoD Directive 1015.14 canceled DoD Directive 1015.1 and, in turn, was canceled by DoD Instruction 1015.14. Therefore, DoD Instruction 4105.71 is using a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of the instruction, DoD needs to update reference (b) with DoD Instruction 1015.14.

**J. DoD Regulation 1015.8, “DoD Civilian Employee Morale, Welfare, and Recreation (MWR) Activities and Supporting Nonappropriated Fund Instrumentalities (NAFIs) Regulation,” November 1985**

- 1.a. **Paragraph C3.2.4.2.** DoD Directive 1015.1 (reference (a)) requires DoD Components to provide for the periodic review and audit of NAFIs. Audits also concern the authorization for functions being performed, as well as their being conducted in accordance with the policies referenced herein. In accordance with DoD Instruction 7600.6 (reference (I)), the normal NAFI audit cycle is every other fiscal year.
- 1.b. **Recommended Change.** Change the paragraph to read as follows: DoD Instruction 1015.14<sup>29</sup> shall require the Heads of the DoD Components to review and audit NAFIs periodically. The purpose of the reviews and audits is to determine whether there is a continued need for the functions being performed and whether those needs comply with sound business practices. NAF audit policy is explained in DoD Instruction 7600.6.

---

<sup>28</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

<sup>29</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to Guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

- 1.c. **Justification.** DoD Directive 1015.14 canceled DoD Directive 1015.1 which, in turn, was canceled by DoD Instruction 1015.14. The wording in DoD 1015.8 Regulation should refer to the current guidance.

**K. DoD Instruction 7600.6, “Audit of Nonappropriated Fund Instrumentalities and Related Activities,” January 16, 2004**

- 1.a. **Paragraph E2.1.3.** Annual financial audits, as defined by reference (d), shall be conducted for all NAFIs with annual revenues or expenses that exceed \$7 million and those NAFIs with operations deemed to be highly sensitive (e.g., potential fraud, large public exposure, etc.). The Office of the IG DoD shall approve exceptions to the dollar limitation in writing. Other audits should be completed as deemed necessary by management based on risk assessments and within resource availability.
- 1.b. **Recommended Change.** Change the paragraph to read as follows: Annual financial statement audits, as defined by reference (d), shall be conducted for all NAFIs with annual revenues or expenses that exceed \$7 million and those NAFIs with operations deemed to be highly sensitive (e.g., potential fraud, large public exposure). Each of the Military Services shall require annual consolidated financial statement audits for each of the six Program Groups as defined by DoD Instruction 1015.14,<sup>30</sup> section 4.3, with annual revenues or expenses that exceed \$1 million. The DoD OIG shall approve exceptions to the dollar limitation in writing. Other audits should be completed as deemed necessary by management, based on risk assessments and availability of resources.
- 1.c. **Justification.** In response to the President’s Management Agenda, DoD established a goal of achieving an unqualified audit opinion; the PDUSD(P&R) also took the initiative to achieve the same for the nonappropriated funds Program Groups under its purview. The PDUSD(P&R) wants consolidated financial statements for each Program Group at the Military Service level audited. Although current guidance provides that all NAFIs with annual revenues or expenses that exceed \$7 million are subject to annual financial audits, the guidance does not discuss the need to have annual financial statement audits for each of the consolidated Program Groups, as defined by DoD Instruction 1015.14, section 4.3. Each of the Military Services has a unique corporate structure that establishes the number of NAFIs for each Program Group, but, on a stand-alone basis, many of these NAFIs have income or expenses that are below the required threshold for an annual financial audit. Our research documented the Program Group’s audited financial statements for each exchange and for most of the Marine Corps and Navy Program Groups. However, with the exception of Army and Air Force Exchange Service, the Army and Air Force failed to produce any audited consolidated financial statements for each Program Group at the Military Service level because the current guidance permits it. The change to DoD Instruction 7600.6 will require the Army and the Air Force to comply with the intention of PDUSD(P&R) to obtain audited consolidated Program Group financial statements, in accordance with the President’s Management Agenda.

---

<sup>30</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to Guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

- 2.a. **Paragraphs E2.1.3 and E.2.1.3.1.** Although both paragraphs refer to financial audit(s), paragraph E.2.1.3.2 refers to audited financial statements.
- 2.b. **Recommended Change.** Inserting the word “statement” after the word “financial” in paragraph E2.1.3 and E.2.1.3.1.
- 2.c. **Justification.** To be consistent within DoD Instruction 7600.6, section E.2.1.3, the word “statement” should be inserted after the word “financial” in sections E.2.1.3 and E.2.1.3.1.

**L. DoD Instruction 1015.12, “Lodging Program Resource Management,” October 30, 1996**

- 1.a. **Page 1, Reference (d).** (d) DoD Directive 1015.1, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities,” August 19, 1981.
- 1.b. **Recommended Change.** (d) DoD Instruction 1015.14, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources” November 22, 2005.<sup>31</sup>
- 1.c. **Justification.** DoD Directive 1015.14 canceled DoD Directive 1015.1 which, in turn, was canceled by DoD Instruction 1015.14. Therefore, DoD Instruction 1015.12 is using a DoD directive that no longer exists as a basis for some of its requirements. To preserve the integrity of this instruction, DoD needs to update reference (d) of this instruction with DoD Instruction 1015.14.
- 2.a. **Page 1, Paragraph 2.1.** (including the Coast Guard when it is not operating as a Military Service in the Navy by agreement with the Department of Transportation)
- 2.b. **Recommended Change.** The reference to the Department of Transportation should be substituted with the Department of Homeland Security.
- 2.c. **Justification.** The Coast Guard no longer falls under the Department of Transportation during peacetime; it is part of the Department of Homeland Security.
- 3.a. **Page 11, Paragraph. 5.2.6.** Submit all management and financial reports to the Assistant Secretary of Defense (Force Management Policy) reflecting personnel and financial management data in accordance with DoD Instructions 1015.10, 1015.1, 7000.12, 1330.20 and DoD 7000.14-R, volume 13 (references (b), (d), (e), (f), and (g)).

---

<sup>31</sup>The DoD Instruction 1015.15 is being revised and will cancel DoD Instruction 1015.14 when it is published. Any suggested changes to guidance with a reference to the DoD Instruction 1015.14 should be substituted with DoD Instruction 1015.15 at the time of publication.

- 3.b. **Recommended Change.** Submit all management and financial reports to the Assistant Secretary of Defense (Force Management Policy) reflecting personnel and financial management data in accordance with DoD Instructions 1015.10, 1015.14, 1330.20 and DoD 7000.14-R, volume 13 (references (b), (d), (e), (f), and (g)). The PDUSD(P&R) should also consider whether to add DoD Instruction 1015.15 as a reference in this paragraph.
- 3.c. **Justification.** DoD Instruction 1015.1 is not referenced in this document; reference (d), which is identified in this paragraph, is for DoD Directive 1015.1. Therefore, the auditors concluded that this paragraph erroneously refers to DoD Instruction 1015.1, when it should refer to DoD Directive 1015.1. Furthermore, as previously stated, DoD Directive 1015.1 was canceled by DoD Directive 1015.14 and, in turn, was canceled by DoD Instruction 1015.14. Therefore, in the auditors' opinion, the reference to DoD Directive 1015.1 should be substituted with DoD Instruction 1015.14. In addition, DoD Instruction 7000.12, "Financial Management of Morale, Welfare, and Recreational Activities," May 27, 1987, was canceled and incorporated into DoD 7000.14. As a result, the auditors concluded that the reference to DoD Instruction 7000.12 paragraph 5.2.6 should be eliminated. The PDUSD(P&R) should consider adding a reference to DoD Instruction 1015.15, because it has many requirements related to reporting on DoD NAFIs.
- 4.a. **Page 14, Reference (e).** (e) DoD Instruction 7000.12, "Financial Management of Morale, Welfare, and Recreational Activities," May 27, 1987.
- 4.b. **Recommended Change.** (e) DoD 7000.14-R, "Financial Management Regulation," current edition.
- 4.c. **Justification.** Enclosure 1 of DoD Instruction 7000.14, "DoD Financial Management Policy and Procedures," November 15, 1992, states that DoD Instruction 7000.12 was canceled and incorporated into the DoD FMR. Therefore, DoD Instruction 1015.12 is using a DoD instruction that no longer exists as a basis for some of its requirements. To preserve the integrity of this instruction, DoD needs to update reference (e) of this instruction with the DoD FMR.

## Appendix E



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

NOV 30 2006

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE  
(COMPTROLLER)/CHIEF FINANCIAL OFFICER

SUBJECT: Agreed-Upon Procedures Covering the Financial Reporting Practices for  
Nonappropriated Fund Instrumentalities and Related Activities  
(Project No. D2006-D000FH-0120.000)

The Office of the Principal Deputy Under Secretary of Defense for Personnel and Readiness (Policy Office) performs an annual review of the Nonappropriated Fund Instrumentality (NAFI) consolidated Program Group financial statements (Reports) forwarded by the Military Services. During the Policy Office review of the FY 2004 Reports, officials discovered unreconcilable equity transfers between headquarters and field activities; noncompliance with DoD accounting policy for NAFI construction-in-progress; and prior period adjustments. Based on a goal of achieving an unqualified audit opinion on the NAFI Program Group Reports, the Policy Office requested that auditors from the DoD Office of the Inspector General (DoD OIG) review the financial reporting practices for NAFI. The review covered four primary areas: DoD policies, accounting for construction-in-progress, eliminating entry transactions between headquarters and installations or regions and between headquarters funds, and prior period adjustments.

As part of our agreed-upon procedures with the Policy Office covering the review of DoD policies, we reviewed the DoD 7000.14, "Financial Management Regulation, volume 13, Nonappropriated Funds Policy and Procedures," January 2004, which falls under the purview of the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. DoD Financial Management Regulation prescribes policy and guidance for financial reporting, financial statements, and financial statement audits of NAFIs. Therefore, we are suggesting changes to the previously identified regulation that, if implemented, would improve financial reporting for NAFIs.

Should you have any questions, please contact me or Mr. Joseph A. Guba at (703) 325-0433.

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

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

Attachment:  
As stated

Suggested Changes by the Office of the Inspector General of the Department of Defense to DoD “Financial Management Regulation, volume 13, Nonappropriated Funds Policy and Procedures,” January 2004, Under the Purview of the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer.

### **Overall Comments**

The Principal Deputy Under Secretary of Defense (Personnel and Readiness) (PDUSD[P&R]) is responsible for nonappropriated fund policy for the DoD Military Morale, Welfare, and Recreation programs, military exchange services, and other authorized Nonappropriated Fund Instrumentalities and Related Activities (NAFI)s. Further, the PDUSD(P&R) has the responsibility to develop, promulgate, and monitor compliance with the policy and other guidance for the proper administration of NAFIs and management of their resources. The Office of the Under Secretary of Defense for Personnel and Readiness (Policy Office) performs an annual review of the NAFI consolidated Program Group financial statements (Report(s))<sup>32</sup> forwarded to their office by the Military Services. During the Policy Office review of the FY 2004 Reports,<sup>33</sup> officials discovered unreconcilable equity transfers between headquarters and field activities; noncompliance with DoD accounting policy for NAFI construction-in-progress; and prior period adjustments. Based on the findings and in response to the President’s Management Agenda of establishing a goal of achieving an unqualified audit opinion, the Policy Office took the initiative to achieve the same for the nonappropriated funds Program Groups<sup>34</sup> under its purview. The Policy Office requested that auditors from the DoD Office of the Inspector General (DoD OIG) review the financial reporting practices for NAFI. The review covered four primary areas: DoD policies, accounting for construction-in-progress, eliminating entry transactions between headquarters and installations or regions and between headquarters funds, and prior period adjustments.

As part of the agreed-upon procedures between the Policy Office and the DoD OIG, we reviewed the requirements in the DoD 7000.14, “Financial Management Regulation (FMR), volume 13, Nonappropriated Funds Policy and Procedures,” January 2004, that affect the financial reporting and the ability of DoD NAFIs to attain unqualified audit opinions on the consolidated financial statements by the Program Groups for each Military Service. The DoD FMR, volume 13, is under the purview of the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer (OUSD(C)/CFO).

The following are the DoD OIG suggested changes to DoD FMR, volume 13 that will improve financial reporting and assist the Military Services in obtaining unqualified audit opinions on their Program Groups’ consolidated financial statements.

---

<sup>32</sup>The Military Services refer to these Reports as 1015.15 Submissions, so for the purposes of this report we will refer to these documents as Report(s).

<sup>33</sup>DoD Instruction 1015.15, “Procedures for Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” May 25, 2005, paragraph 5.5.2 states the following: “A consolidated financial and management report shall be prepared annually for each Military Service and Joint Service NAFI. Each consolidated report shall contain the financial statements and reports specified at enclosure 7. Ten copies of the annual report shall be submitted to the PDUSD(P&R) within 120 days following the close of the Program Group fiscal year. The reports shall be based on or be the basis of annual financial statements that comply with the audit requirements of DoD Instruction 7600.6 (reference (ae)).”

<sup>34</sup>DoD Instruction 1015.14, paragraph 4.3, provides that DoD programs or activities and their supporting NAFIs are classified into one of six Program Groups which are Military Morale, Welfare, and Recreation (MWR), Armed Services Exchange Programs, Civilian MWR, Lodging Program, Supplemental Mission Funds, and Special Purpose Central Funds.



**A. DoD “Financial Management Regulation, Volume 13, Chapter 1, Nonappropriated Fund Accounting,” January 2004**

- 1.a. **DoD FMR, Volume 13, Chapter 1, Page 1-5, Section 010202 E. Materiality.** “Materiality refers to whether the information is significant enough to make a difference to a reasonable person who relies on the information. For example, a decision not to disclose information in the financial statements may be made if the amounts involved are too small to make a difference or affect the reliability of the information. In addition to magnitude, the nature of the item shall be considered when making a materiality judgment. Report any information that is material in the financial statements.”
- 1.b. **Recommended Change.** “Materiality refers to whether the information is significant enough to make a difference to a reasonable person who relies on the information. For example, a decision not to disclose information in the financial statements may be made if the amounts involved are too small to make a difference or affect the reliability of the information. For reporting purposes that require the level of materiality to be quantified, materiality shall be defined as 1 percent of the total assets in the balance sheet for each NAF activity. For those NAF activities required to report on a consolidated basis, the threshold of materiality shall be 1 percent of the assets in the consolidated balance sheet.” This threshold should not be included in the statement of work for external audits.
- 1.c. **Justification.** During the course of the NAFI research project, the DoD OIG was advised by the responsible officials of each Military Service that DoD needed to establish a specific methodology to compute the threshold for materiality. Financial management decisions are different at each of the Military Services, based on their interpretation of materiality. Because DoD is a capital-intensive entity, the assets provide a consistent base across the reporting entities. As a result, all reporting entities will use the assets for computing materiality. In their FY 2005 planning, the DoD OIG established 1 percent of the asset base as the level of materiality for testing. The 1 percent materiality threshold should not be used in developing a Statement of Work (SOW) for an Independent Public Accounting (IPA) firm and must be clearly described as a threshold established by the PDUSD(P&R) that applies to internal reporting.
- 1.d. The 1 percent materiality threshold should not be used in the SOW because it does not identify whether it applies to planning, design, or test materiality, and the threshold base may not be appropriate for the various types of reporting entities. Further, by establishing a 1 percent materiality threshold in the SOW, the IPA may consider it to be a scope limitation. For SOW purposes, the PDUSD(P&R) or OUSD(C)/CFO may want to include a requirement in both the DoD Instruction 1015.15, “Establishment, Management, and Control of Nonappropriated Fund Instrumentalities and Financial Management of Supporting Resources,” (currently in coordination) or DoD “FMR, volume 13, chapter 10, Miscellaneous,” August 1994, stating that the SOW must require the IPA to follow the current version of the methodology that the General Accountability Office and the President’s Council on Integrity and Efficiency Financial Audit Manual uses.
- 1.e. In addition, the PDUSD(P&R) or OUSD(C)/CFO (Policy Offices) could establish the 1 percent materiality threshold for internal reporting. The Policy Offices could also establish an internal reporting process requiring entities to report

certain adjustments to them as part of management reports. However, the Policy Offices must clarify that the threshold does not preclude entities from making necessary adjustments to financial statements for transactions that may fall below the threshold. The Policy Offices must also acknowledge that the adjustments that fall below its established threshold may be material in the aggregate.

- 2.a. **DoD FMR, Volume 13, Chapter 1, Page 1-6, Section 010203, paragraph B. Generally Accepted Accounting Principles (GAAP) Hierarchy.** “A GAAP hierarchy has been established that identifies five categories or sources of GAAP (listed below in descending order of importance).
- 1.) Officially established accounting principles that consist of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board (APB) Opinions, and American Institute of Certified Public Accountants (AICPA) Accounting Research Bulletins.
  - 2.) The FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.
  - 3.) The AICPA Accounting Standards Executive Committee promulgations that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force.
  - 4.) The AICPA accounting interpretations and implementation guides (“Qs and As”) published by the FASB staff, and practices that are recognized widely and prevalent either generally or in the industry.
  - 5.) Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; Government Accounting Standards Board (GASB) Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles.”
- 2.b. **Recommended Change.** The Policy Offices should determine whether the NAFI accounting practices must comply with the accounting standards promulgated by the FASB or by the Federal Accounting Standards Advisory Board (FASAB) and revise the paragraph accordingly.
- 2.c. **Justification.** The FASAB accounting principles are also considered to comply with GAAP as defined in American Institute of Certified Public Accountants (AICPA) Codification of Auditing Standards, AU 411.14. Federal entities can rely on FASB pronouncements, if the FASAB made those pronouncements specifically applicable to Federal Government entities. Further, the DoD FMR, volume 13, chapter 1, Section 010203, paragraph B, “GAAP Hierarchy,” only identifies FASB as being part of the GAAP hierarchy, which may indicate that DoD intended that the NAFIs should use FASB accounting principles. It should be stated that the FASAB website states the following in relation to GAAP hierarchy:

The AICPA Council designated FASAB as the body that establishes accounting principles for Federal entities. The AICPA’s hierarchy of generally accepted accounting principles in Statement of Auditing

Standards (SAS) No. 91, The Federal GAAP Hierarchy, governs what constitutes GAAP for U.S. Government reporting entities. The hierarchy lists the priority sequence of sources that an entity should look to for accounting and reporting guidance.

- 3.a. **DoD FMR, Volume 13, Chapter 1, Page 1-8, Section 0104. “ACCOUNTING PERIOD.** The accounting period for the DoD NAF organizations (except the Exchange Services) as set by DoD Instruction 7000.12, “Financial Management of Morale, Welfare, and Recreational Activities,” begins October 1 of each year and ends September 30 of the next year. The Under Secretary of Defense (Comptroller) shall approve exceptions in writing.
- 3.b. **Recommended Change.** The reference to DoD Instruction 7000.12, “Financial Management of Morale, Welfare, and Recreational Activities,” May 27, 1987, should be removed from the section because it was canceled. Therefore, this section should just either state the requirement for the accounting period or refer to DoD Instruction 1015.15, which states the same requirement that appears in this section.
- 3.c. **Justification.** DoD Instruction 7000.12 was canceled and incorporated into DoD FMR. Therefore, section 0104 of the DoD FMR refers to an instruction that no longer exists, and its requirements were incorporated into the DoD FMR. Therefore, to preserve the integrity of this regulation, the reference to DoD Instruction 7000.12 should either be eliminated or substituted with a reference to DoD Instruction 1015.15.

## **B. DoD “FMR, Volume 13, Chapter 2, General Ledger and Coding Structure,” August 1994**

- 1.a. **DoD FMR, Volume 13, Chapter 2, Page 2-1, Par. 0201. “NONAPPROPRIATED FUND ACCOUNTING CLASSIFICATION CODES.** The Defense Finance and Accounting Service is developing a uniform system for coding transactions to insure consistency in financial management procedures as well as flexibility in application to either manual or mechanized accounting records in the NAF area. When the standard general ledger account code structure is completed and approved it will be incorporated in this chapter. In the meantime, accounting offices will continue to use their current account code structure until further notice.”
- 1.b. **Recommended Change.** DoD FMR, volume 13, chapter 2 needs to be rewritten to include a uniform chart of accounts that all of the DoD NAFIs will be required to use. To maintain consistency and to make the transition to a NAFI standard chart of accounts easier, DoD should base the new NAFI standard chart of accounts on the most current version of the Armed Service Exchange standard chart of accounts, which was distributed by the Deputy Under Secretary of Defense for Military Community and Family Policy (DUSD(MC&FP)).
- 1.c. **Justification.** DoD NAFIs are using at least four different charts of accounts. The Army’s chart of accounts appears in the DoD FMR, volume 13, Appendix A. The Department of the Navy’s (Navy and Marine Corps) chart of accounts appears in the DoD FMR, volume 13, Appendix C. Furthermore, Navy NAFIs that fall under the purview of the Commander, Navy Installations Command use the Recreation and Mess Central Accounting System User Handbook FY 2006

Edition, dated October 2005, which includes its own chart of accounts. In addition, the Air Force has a separate chart of accounts for its NAFIs that were published in Air Force Manual 34-214, "Procedures for Nonappropriated Funds Financial Management and Accounting," February 14, 2006. On June 1, 2005, the DUSD(MC&FP) published the most current version of the Armed Service Exchange's standard chart of accounts. The discovery of these five charts of accounts led the auditor to review them and later determine that DoD NAFIs were using at least five different charts of accounts; thus, in our opinion, DoD NAFIs are not using consistent chart of accounts.

Additionally, during a meeting with representatives of the Policy Offices and the DoD OIG on June 27, 2006, the DoD OIG suggested eliminating the Army, Navy, and Air Force appendices. The OUSD(C)/CFO agreed to eliminate those three appendices, but stated that the FMR was not specific. As a result, the DoD OIG concluded that to make the DoD NAFIs accounting information both comparable and consistent, as defined by the DoD FMR, volume 13, chapter 1, the OUSD(C)/CFO should implement a uniform chart of accounts for all of the DoD NAFIs. To maintain consistency and to make the transition to a standard NAFI chart of accounts easier, DoD should base the new NAFI standard chart of accounts on the most current version of the Armed Service Exchange's standard chart of accounts.

- 2.a. **Requirement for the NAFIs to use the United States Standard General Ledger (USSGL).**
- 2.b. **Recommended Change.** The OUSD(C)/CFO should either develop a uniform chart of accounts for the NAFIs that is based on the most current version of the Armed Service Exchange's standard chart of accounts or develop a hybrid uniform chart of accounts that is based on the USSGL. In addition, the Policy Offices should come to a consensus on what the uniform standard chart of accounts will be for all NAFIs and include it in the DoD FMR, volume 13, chapter 2 and DoD Instruction 1015.15.
- 2.c. **Justification.** The OUSD(C)/CFO informed the DoD OIG that it planned to implement a standard chart of accounts based on the USSGL. However, the PDUSD(P&R) informed the DoD OIG that the Armed Service Exchanges are not bound by the DoD FMR, volume 13. As a result, if the OUSD(C)/CFO includes a requirement for the DoD NAFIs to use the USSGL, then all of the NAFIs except for the exchanges will be obligated to implement this change. Therefore, DoD could potentially have two separate uniform standard general ledgers for its NAFIs, which would create conflict between the policies. To prevent this conflict, the Policy Offices should coordinate their implementation of the new uniform chart of accounts, and include it in the DoD FMR, volume 13, chapter 2 and the DoD Instruction 1015.15. It should also be noted that some of the USSGL accounts might not apply to the NAFIs, while others might not satisfy the NAFIs needs because they are revenue generating entities rather than budgeting entities like the majority of the activities that follow the USSGL. The DoD OIG auditors suggest that OUSD(C)/CFO implement either a hybrid uniform chart of accounts based on the USSGL or use the chart of accounts that the exchanges currently use to facilitate the transition from multiple charts of accounts to a single uniform chart of accounts.

## **C. DoD “FMR, Volume 13, Chapter 3, Assets,” August 1994**

- 1.a. **DoD FMR, Volume 13, Chapter 3, Page 6, Section 030301, Paragraph A.** “however, interest charges should not be capitalized.”
- 1.b. **Recommended Change.** Material amounts of interest paid also need to be capitalized as part of the acquisition cost of a fixed asset.
- 1.c. **Justification.** The Statement of Federal Financial Accounting Standard (SFFAS) No. 6 states that material amounts of interest paid also need to be capitalized as part of the acquisition cost of the fixed asset. SFFAS No. 6 defines “interest cost” “as any interest paid by the reporting entity directly to providers of goods or services related to the acquisition or construction of PP&E.” Therefore, we concluded that the DoD FMR, volume 13, chapter 3 conflicts with SFFAS No. 6. As a result, we suggest that the DoD FMR, volume 13, chapter 3 be rewritten to match the requirements found in SFFAS No. 6.
- 2.a. **Page 6, Section 030301, Paragraph A, Item 2.** “Self-Constructed Assets. If fixed assets are built or manufactured by the NAFI, all costs incurred, materials, permits, taxes, insurance and overhead costs should be capitalized in accordance with the appropriate appendices.”
- 2.b. **Recommended Change.** This paragraph should read as follows: “If fixed assets are built or manufactured by the NAFI, all costs incurred, materials, permits, taxes, insurance, and overhead costs should be capitalized in either a construction-in-progress (if the asset is real property) or work-in-progress (if the asset is personal property) account. Upon completion, all of the accumulated costs will be transferred to the appropriate fixed-asset account.”
- 2.c. **Justification.** The current reference to the Military Department Appendices gives the Military Services the authority to arbitrarily develop guidance on the capitalization of self-constructed assets. However, to ensure both comparability and consistency, as defined by the DoD FMR, volume 13, chapter 1, of the accounting information generated by the NAFIs, the OUSD(C)/CFO needs to establish uniform guidance for capitalizing self-constructed assets, and the guidance in question must follow the standards set by either FASB or FASAB. Furthermore, SFFAS No. 6 states: “In the case of constructed PP&E, the PP&E shall be recorded as construction work in process until it is placed in service, at which time the balance shall be transferred to general PP&E.” Therefore, the costs listed in section 030301 for self-constructed assets should be capitalized in either a construction-in-progress (if the asset is real property) or work-in-progress (if the asset is personal property) account, while it is under construction. After the assets in question have been built, then either the construction-in-progress or the work-in-progress account should be credited, and the appropriate asset account should be debited. In addition, during a meeting with representatives of the policy offices and the DoD OIG, on June 27, 2006, the DoD OIG suggested that the Army, Navy, and Air Force appendices should be eliminated. The OUSD(C)/CFO agreed to eliminate the three appendices, but stated that the DoD FMR was not specific. As a result, the existing reference to the appendices will have to be removed, since OUSD(C)/CFO stated that the Military Department appendices will be removed from the DoD FMR, volume 13. Therefore, the auditors concluded that if OUSD(C)/CFO carries on with its plan to remove the Military Departments’ appendices, then it will be forced to change the references

in DoD FMR, volume 13, chapter 3. (The DoD FMR includes a consistent erroneous reference to Service Appendices, when in fact it refers to the three Military Department Appendices).

- 3.a. **DoD FMR, Volume 13, Chapter 3, Page 10, Section 030301, Paragraph I, Bullet 1.b.** “Estimate the Useful Life of the Asset. A reliable source for determining the useful life of the asset is the experience with similar assets.”
- 3.b. **Recommended Change.** To maintain consistency across the DoD, OUSD(C)/CFO should include an assets table in this chapter for DoD Recovery Periods for Depreciable General PP&E that mirrors the one in DoD FMR, volume 4, chapter 6. In addition, this schedule should supersede the one that appears in the DUSD(MC&FP) Memorandum, “DoD Nonappropriated Fund Instrumentalities (NAFI) Financial Reports,” June 1, 2005, which applies only to exchanges.
- 3.c. **Justification.** Because the current version of the DoD FMR, volume 13, chapter 3, lacks a Recovery Period (useful lives) for Depreciable Assets Schedule, the Military Services designed their own. As a result of the lack of standardized guidance, each Military Service and, in many instances, individual NAFIs use varying useful lives for the same type of asset. DoD is not applying consistent useful lives to all of its long-lived assets. Therefore, the information being reported in the financial statements of the DoD NAFIs is not comparable; thus the users of the financial statements cannot compare a given NAFI performance against any of the other NAFIs that operate within DoD. In conclusion, if DoD wishes to have consistent accounting policies for depreciation for the entire agency, it should use the same schedule for useful lives that appears in the DoD FMR, volume 4, chapter 6 for all of its capitalized assets including the ones that are managed by NAFIs.
- 4.a. **DoD FMR, Volume 13, Chapter 3, Page 10, Section 030301, Paragraph I, Bullet 1.c.** “Estimate the Salvage Value for the Asset. The value, if any, remaining at the end of an asset’s useful life may, if allowed by the appropriate appendices, be subtracted from the acquisition cost of the asset before computing depreciation.”
- 4.b. **Recommended Change.** The DoD FMR, volume 13, chapter 3 should include the same requirements for salvage value that appear in the DoD FMR, volume 4, chapter 6: “The salvage value, also known as the residual or scrap value, is the amount that would be expected to be obtained from selling the asset at the end of its useful life, but only when such proceeds (from recycle, resale, and salvage) are permitted to be retained and used by the DoD Component. Typically, personal property, for example, vehicles, ADP and equipment, will not have a salvage value. If the asset is to be traded in on a new asset, the salvage value is the expected trade-in value. For purposes of computing depreciation, real property assets such as buildings, facilities and structures do not have salvage values.”
- 4.c. **Justification.** The DoD FMR, volume 13, chapter 3 does not specify the amount to be used as salvage value during the calculation of the depreciation of long-lived assets. As a result, each Military Service is allowed to set varying salvage values for all of the assets that DoD NAFIs managed. Therefore, under the existing regulation, each Military Service can use a salvage value for a given type of asset, while another Military Service can give the very same type of asset a different salvage value. The situation becomes even more complex if the Military

Services assign different salvage values for the same type of asset within the Military Service or Program Group. If the NAFIs are allowed to modify the salvage values as they see fit, the depreciation expense being reported in the financial statements could be manipulated in such a way that the bottom line of the NAFIs would not accurately portray their financial performance during the fiscal year. In conclusion, if DoD wishes to have consistent accounting policies for depreciation across the entire agency, it should use the same salvage values that are described in the DoD FMR, volume 4, chapter 6 for all of its capitalized assets, including the ones that NAFIs managed.

#### **D. DoD “FMR, Volume 13, Chapter 5, Revenue,” August 1994**

- 1.a. **DoD FMR, Volume 13, Chapter 5, Page 0, Section 0501, General, Last Sentence.** “Revenue will be recorded in accordance with the appropriate Service appendix.”
- 1.b. **Recommended Change.** The OUSD(C)/CFO should substitute the reference to the Service appendices with its own guidance on revenue recognition, which needs to agree with the standards set by either the FASB or the FASAB.
- 1.c. **Justification.** The existing reference to the Service appendices authorizes the Military Departments to arbitrarily develop guidance on revenue recognition. However, to ensure the comparability and consistency of the accounting information generated by the NAFIs, as defined by the DoD FMR, volume 13, chapter 1, the OUSD(C)/CFO needs to establish uniform guidance on revenue recognition that follows the standards set by either FASB or FASAB. In addition, during a meeting with representatives of the Policy Offices and the DoD OIG on June 27, 2006, the DoD OIG suggested that the Army, Navy, and Air Force appendices should be eliminated. The OUSD(C)/CFO agreed to eliminate them, but stated that the DoD FMR was not specific. As a result, the existing reference will have to be removed, because the OUSD(C)/CFO stated that the Military Department appendices must be removed from the DoD FMR, volume 13. Therefore, the DoD OIG concluded that if OUSD(C)/CFO carries on with its plan to remove the Military Department appendices, it will be forced to change the reference in the DoD FMR, volume 13, chapter 5 for the appendices in question.

#### **E. DoD “FMR, Volume 13, Chapter 6, Expenses,” August 1994**

- 1.a. **DoD FMR, Volume 13, Chapter 6, Page 0, Section 0601, General, Last Sentence.** “Until further notice, expenses will be recorded in accordance with the appropriate Service appendix.”
- 1.b. **Recommended Change.** The OUSD(C)/CFO should substitute the reference to the Service appendices with its own guidance on recording expenses, which must agree with the standards set by either the FASB or the FASAB.
- 1.c. **Justification.** The current reference to the “Service” (Military Department) appendix authorizes the Military Departments to arbitrarily develop guidance on recording expenses. However, to ensure both comparability and consistency of the accounting information generated by the NAFIs, as defined by the DoD FMR, volume 13, chapter 1, the OUSD(C)/CFO needs to establish uniform guidance for

recording expenses, and the guidance in question must follow the standards set by either FASB or FASAB. In addition, during a meeting with representatives of the Policy Offices and the DoD OIG on June 27, 2006, the DoD OIG suggested that the Army, Navy, and Air Force appendices should be eliminated. The OUSD(C)/CFO agreed to eliminate them, but stated that the DoD FMR was not specific. As a result, the existing reference must be removed, because the OUSD(C)/CFO stated that the Military Department appendices must be removed from the DoD FMR, volume 13. Therefore, the DoD OIG concluded that if the OUSD(C)/CFO continues with its plan to remove the Military Department appendices, it will be forced to change the reference in DoD FMR, volume 13, chapter 6 for the appendices in question.

**F. DoD “FMR, Volume 13, Chapter 7, Financial Reporting,” August 1994**

- 1.a. **DoD FMR, Volume 13, Chapter 7, Page 1, Section 070103. Financial Statements.** “Financial Statements. The principal financial statements used to convey information to users are the statement of financial position or balance sheet, statement of operations or income and expense statement, and the statement of cash flows. These reports provide information on the financial performance and condition of the NAFI as follows:
  - 1.) The statement of financial position (or balance sheet) provides information about an activity’s economic resources, obligations, and equity. That information helps users identify the activity’s financial strengths and weaknesses and assess its liquidity and solvency.
  - 2.) The statement of financial position (or income and expense statement) provides information about the activity’s financial performance during a specified period of time.”
- 1.b. **Recommended Change.** Paragraph 2 of this section should be rewritten as follows: The statement of operations (or income and expense statement) provides information about the activity’s financial performance during a specified period of time.
- 1.c. **Justification.** The initial paragraph of this section identifies the “statement of operations” as an income and expense statement, while the same paragraph identifies the “statement of financial position” as the balance sheet. As a result, the DoD OIG concluded that bullet 2 of section 070103 erroneously refers to the income and expense statement as the statement of financial position. Therefore, to maintain consistency across section 070103, the reference to the “statement of financial position” should be replaced with “statements of operations.”
- 2.a. **DoD FMR, Volume 13, Chapter 7, Page 1, Section 070103. Financial Statements.**
- 2.b. **Recommended Change.** The policy offices should coordinate to determine if they would like to set specific guidance on the form and content of the DoD NAFI financial statements or use the DoD form and content.
- 2.c. **Justification.** During this audit research project, the DoD OIG reviewed various



financial statements that the DoD NAFIs published, and discovered that they did not consistently include the same documents. Although all of the financial statements included the balance sheet, income and expense statement, and the cash flow statements, some NAFIs limited their financial statement to those three documents and the footnotes to the statements, while others included other documents within their financial statements. Therefore, to maintain uniformity among the NAFIs, the DoD OIG suggested that the Policy Offices coordinate to determine if they want to set specific guidance on the form and content of the DoD NAFI financial statements.

- 3.a. **DoD FMR, Volume 13, Chapter 7, Page 2, Section 070105. Cash Basis of Accounting.** “Financial statements, reports, and other information from activities authorized to use the cash basis of accounting shall be prepared in accordance with generally accepted accounting principles. The statements differ from those described above.”
- 3.b. **Recommended Change.** To maintain consistency and comparability of the financial information reported by NAFIs, as defined by the DoD FMR, volume 13, chapter 1, and to clarify this regulation, section 070105 Cash Basis Accounting should be removed from the DoD FMR, volume 13, chapter 7.
- 3.c. **Justification.** The statement “activities authorized to use the cash basis of accounting” implies that some NAFI activities are allowed to use the cash basis of accounting, while others are required to use other types of accounting basis (which are undefined in this chapter). It should be noted that the DoD FMR, volume 13, chapter 10 states that “NAFIs are required to use the accrual method of accounting unless specifically authorized by the DoD Components to use the cash method of accounting.” In addition, DoD FMR, volume 13, chapter 10 adds the following statement: “This section prescribes a uniform cash method of accounting and reporting system applicable to small NAFIs. These procedures represent a single entry cash basis system of accounting and prescribe statements which will reflect the financial condition of the various activities on a standardized basis.” However, because the DoD FMR, volume 13 requires some NAFIs to use the accrual method and allows “small” NAFIs to use the cash method of accounting at the same time, it causes the DoD NAFIs accounting methods to be inconsistent. In addition, the different accounting methods being used by the NAFIs will cause problems with consolidating the NAFI financial statements by Program Group.
- 3.d. Also, AICPA Professional Standards AU Section 623, Special Reports (AU 623) identifies “cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support” as a comprehensive basis of accounting other than GAAP. Based on AU 623’s definition of comprehensive basis of accounting, the DoD OIG concluded that the cash basis of accounting is not considered GAAP. In addition, in the DoD OIG’s opinion, requiring financial statements, reports, and other information recorded using a comprehensive basis of accounting to comply with GAAP is a contradictory statement because the cash basis of accounting is not considered GAAP. Therefore, the sentence stating: “Financial statements, reports, and other information from activities authorized to use the cash basis of accounting shall be prepared in accordance with generally accepted accounting principles.” is contradictory. As a result, the OIG suggested that this section should be taken out of the DoD FMR, volume 13, chapter 7.

- 4.a. **DoD FMR, Volume 13, Chapter 7, Page 3, Section 0703 RATIOS.** “If requested, DFAS can provide as an example the following ratios.”
- 4.b. **Recommended Change.** Instead of asking the NAFI managers to request copies of the ratios from the Defense Finance and Accounting Service (DFAS), the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer (OUSD((C)/CFO)) should include the formulas for all of the financial ratios that are discussed in this chapter.
- 4.c. **Justification.** The existing version of the DoD FMR, volume 13, chapter 7 includes only brief definitions, some of which are vague, of many ratios, but it does not explain how many of them are calculated. Therefore, including the formulas for calculating the ratios will help to clarify some of the descriptions. In addition, because the DoD FMR, volume 13, chapter 7 is readily available to DoD employees on the OUSD(C)/CFO’s website, it would be easier for NAFI managers to access the ratio formulas on the OUSD(C)/CFO’s website instead of having to request the formulas from DFAS.
- 5.a. **DoD FMR, Volume 13, Chapter 7, Page 3, Section 070302.** “It is referred to as working capital or net current assets. There is general rule that a current ratio of 1.5:1 is satisfactory. Like most generalities this one is subject to modification in certain specific cases.”
- 5.b. **Recommended Change.** The OUSD(C)/CFO should either explain under which specific cases the general rule that a current ratio of 1.5:1 is satisfactory is subject to modification or remove the statement in question from the DoD FMR, volume 13, chapter 7.
- 5.c. **Justification.** By stating that: “Like most generalities, this one is subject to modification in certain specific cases,” the DoD FMR, volume 13, chapter 7 is stating that the NAFIs are not required to maintain a current ratio of 1.5:1, thus the statement is not binding. In addition, DoD FMR, volume 13, chapter 7 states that the general rule is subject to modification in certain specific cases, but it fails to identify the specific cases. As a result, the NAFI managers do not know under which “certain specific cases” they are allowed to deviate from a current ratio of 1.5:1. Therefore, the sentence in question defeats its own purpose.
- 6.a. **DoD FMR, Volume 13, Chapter 7, Page 5, Section 070306.** “Merchandise Inventory Turnover. A ratio of 1 to 1 is generally acceptable for food and bar operations. For all other sales operations, however, NAFI management may establish other goals.”
- 6.b. **Recommended Change.** The OUSD(C)/CFO should either require a merchandise inventory ratio of 1 to 1 for all NAFIs that have merchandise, or state in the DoD FMR, volume 13, chapter 7 the value of the merchandise inventory ratio that, except for food and bar operations, all operations should maintain.
- 6.c. **Justification.** To maintain consistency across all of DoD resale NAFIs, the DoD FMR, volume 13, chapter 7 should require all resale NAFIs to maintain a merchandise inventory ratio of 1 to 1. However, if the needs of the other DoD resale NAFIs differ greatly from the needs of food and bar operations, DoD FMR, volume 13, chapter 7 should require a turnover ratio for specific merchandise inventory for all other DoD resale activities.

- 7.a. **DoD FMR, Volume 13, Chapter 7, Page 5, Section 070307.** “Turnover of Working Capital. This turnover or ratio is composite of number of relationships (inventories, receivables, current liabilities, etc.). These various component elements should be analyzed individually to account for changes from period to period. The turnover of working capital is computed by dividing the net sales for the year by the average working capital.”
- 7.b. **Recommended Change.** OUSD(C)/CFO should identify all of the components of the turnover for a working capital ratio and substitute the word “should” with “need to” or “have to.”
- 7.c. **Justification.** This sentence is vague because it starts listing the elements of the turnover of working capital, but it does not identify all of them. In addition, the next sentence states that “various” elements exist, thus giving the impression that many elements of this ratio were left out; the chapter does not define the elements that form part of the working capital. As a result, the existing chapter does not provide sufficient information to DoD NAFI managers for them to properly calculate the turnover of working capital. It should also be noted that by using the word “should” in this section, OUSD(C)/CFO gives the impression that it is suggesting that the elements should be analyzed individually, instead of requiring the individual analysis of the elements in question. However, by substituting the word “should” with either of the words “need to” or “have to,” OUSD(C)/CFO will be stating clearly that NAFI managers are required to individually analyze the elements that make up the turnover of working capital.
- 8.a. **DoD FMR, Volume 13, Chapter 7, Page 5, Section 070401.** “General. The frequency with which analytical data are furnished is of the utmost importance. It is not enough for management to know at the end of a year, or even a quarter, that costs are increasing more rapidly than revenues. The accountant must often use interim cost standards, ratios, or other devices, in presenting income statement data. Moreover, they must devise adequate methods of accruing items which may not be finally determined until the end of the fiscal year or later, but which are of vital importance in their effect on income.”
- 8.b. **Recommended Change.** The OUSD(C)/CFO should state the frequency with which analytical data will be furnished to management. In addition, the OUSD(C)/CFO should list the specific methods that accountants are required to use to furnish the required analytical data. Finally, the last sentence should not state “they must devise adequate methods of accruing items;” instead, the DoD, FMR volume 13 should define the “adequate methods of accruing,” which must comply with generally accepted accounting principles GAAP or an accepted other comprehensive basis of accounting (OCBOA).
- 8.c. **Justification.** The entire paragraph emphasizes the importance of providing management with data frequently, but it never states how frequently. The paragraph implies that providing the data in question in a yearly or quarterly basis might not be frequent enough, but it never actually states whether the data must be reported to management on a yearly or quarterly basis or even more frequently. As a result, NAFI accountants do not know how frequently they are required to provide analytical data to management. Therefore, the DoD FMR, volume 13, chapter 7 needs to state how frequently the accountants need to report analytical data to management. The statement that: “The accountant must often use interim cost standards, ratios, or other devices, in presenting income statement data” is vague, because it does not tell accountants precisely which “devices” or methods

are the ones that provide the necessary information to management. In addition, the sentence stating that: “they must devise adequate methods of accruing items,” gives the impression that accountants are allowed to devise their own methodology to adequately accrue transactions. In actuality, this sentence should require accountants to book transactions in accordance with GAAP except, if by using GAAP, their financial statements do not accurately portray the entities’ financial posture or a legal requirement contradicts GAAP. In this case, this section should require the accountants to use an OCBOA in those instances when the institution cannot follow GAAP, and the entity should disclose the reason why it used the OCBOA in its financial statements.

9.a. **DoD FMR, Volume 13, Chapter 7, Page 6, Section 070402, Methods and Techniques, Bullet C. Analytical.**

A trend analysis should be made for each NAFI’s financial statement. The analysis of the balance sheet should compare actual to actual and the percentage of increase or decrease be shown. The analysis of the income statement for each activity should compare actual to actual and actual to the budgeted amounts. As with the balance sheet analysis, differences will be shown as a percentage. The analysis should be made by each activity for items such as; sales, cost of goods sold, labor expenses, net income, and all other revenue and expense items with a material financial effect on the activity.

9.b. **Recommended Change.** The OUSD(C)/CFO needs to substitute the word “should” in this paragraph with “shall”. In addition, in the last sentence the OUSD(C)/CFO should either list all of the revenue and expense items that should be analyzed or include a monetary threshold or a methodology that the NAFIs can use to determine whether an item materially affects the NAFI financial statements. **(See section I, paragraphs 1.a. through 1.e. for a discussion on materiality.)**

9.c. **Justification.** By using the word “should” in this paragraph, the DoD FMR, volume 13, chapter 7 gives the impression to the NAFI managers that it is just a suggestion that they follow the procedures, instead of conveying that the activities are required to comply with this guidance. As a result, the NAFIs will conclude that they are not required to comply with this section. To prevent any confusion and to help the NAFIs perform the desired analysis, this section should be rewritten to make it clear that the NAFIs must comply with this section of the DoD FMR, volume 13, chapter 7. In addition, the statement, “all other revenue and expense items with a material financial effect on the activity,” is vague, because it neither identifies the items that should be analyzed nor specifies a methodology that can determine which items have a material financial effect. Therefore, the last sentence of this paragraph needs to either list the specific items to be analyzed or include a monetary threshold or a methodology that the NAFIs can use to determine whether an item has a material effect on the activity.

**G. DoD “FMR, Volume 13, Chapter 8, Payroll,” August 1994**

1.a. **DoD FMR, Volume 13, Chapter 8, Page 0, Section 0801. General.** “Until the Nonappropriated Fund Central Payroll System (NAFCPS) is implemented, all

NAF payroll offices should follow the procedures in the appropriate Service appendix.”

- 1.b. **Recommended Change.** The DoD FMR, volume 13, chapter 8 should either substitute the reference to the “Service appendix” with all of the procedures included in the NAFCPS within this chapter or delete the entire sentence.
- 1.c. **Justification.** The current reference to the “Service appendix” allows each Military Department to treat similar transactions differently; the DoD FMR erroneously refers to these appendices as Service appendices, when in fact they refer to the three Military Departments. As a result, the financial statements generated by each Military Service will not be comparable or consistent, as defined by DoD FMR, volume 13, chapter 1, and will prevent DoD management from being able to compare the performance of the NAFIs of one Military Service against the NAFIs of another Military Service. In addition, the OUSD(C)/CFO informed the DoD OIG of its intent to remove the Military Department appendices from the DoD FMR. Once the Military Department appendices are removed from the DoD FMR, this chapter will be instructing the Military Departments to comply with requirements that no longer exist. Therefore, it is the conclusion of the DoD OIG that to maintain the comparability and uniformity of the NAFI financial statements and the integrity of this regulation, the reference to the “Service appendix” must be either substituted with a DoD requirement or deleted altogether.

#### **H. DoD “FMR, Volume 13, Chapter 9, Internal Controls.” August 1994**

- 1.a. **DoD FMR, Volume 13, Chapter 9, Page 3, Section 090302, Bullet B, Item 2 Reconciliation.** “Regularly scheduled reconciliation of control and subsidiary accounts and records for such things as cash receipts, accounts receivable, inventories, and accounts payable shall be performed to substantiate and maintain the accuracy of account postings and balances by checking the agreement between the sum of the detail in subsidiary accounts with the general ledger control balances.”
- 1.b. **Recommended Change.** The phrase “regularly scheduled” should be replaced with a statement similar to yearly, quarterly, or monthly to clarify the requirements so that all DoD Components perform reconciliations on a consistent basis.
- 1.c. **Justification.** The requirement gives DoD Components too much flexibility when performing the required reconciliations. For example, one DoD Component could perform its regularly scheduled reconciliations once a year, while another might perform them every quarter. This situation could lead to the reconciliations not being performed on a timely basis and procedures not being followed consistently across DoD. As a result, the DoD OIG concluded that the OUSD(C)/CFO should require all DoD Components to perform their reconciliations on a specific basis (yearly, quarterly or monthly) so that the DoD NAFIs perform their reconciliations uniformly.
- 2.a. **DoD FMR, Volume 13, Chapter 9, Page 3, Section 090302, Bullet B, Item 3, Reconciliation.** “General ledger property control accounts shall be periodically

reconciled to detailed property records.”

- 2.b. **Recommended Change.** The term “periodically” should be substituted with a measurable term such as yearly, quarterly, or monthly.
- 2.c. **Justification.** The sentence is too vague, thus allowing the DoD Component and each individual NAFI to determine the frequency with which they will perform the reconciliations. As a result, the way in which this requirement was written led to a lack of uniformity and possibly defeated the purpose of this requirement because many years might pass before the NAFIs perform the required reconciliations. Therefore, it is the recommendation of the DoD OIG that the OUSD(C)/CFO replace the term “periodic” with a requirement to perform the reconciliations on a yearly, quarterly, or monthly basis.
- 3.a. **DoD FMR, Volume 13, Chapter 9, Page 3, Section 090302, Bullet B, Item 4, Reconciliation.** “Accounting records shall be adjusted to be in agreement with the results of physical inventories when they are taken.”
- 3.b. **Recommended Change.** This section should either state when the inventories in question shall be conducted (by item category) or refer to DoD FMR, volume 13, chapter 3 that discusses the frequency of physical inventories.
- 3.c. **Justification.** Currently, the requirement is vague because it does not state how often the physical inventories shall be conducted. Therefore, this section should either state how frequently the physical inventories in question shall be conducted or include a reference to volume 13, chapter 3 that discusses the frequency of physical inventories.
- 4.a. **DoD FMR, Volume 13, Chapter 9, Page 4, Section 090302, Bullet B, Item 5, Reconciliation.** “The results of periodic physical counts of cash and cash items shall be reconciled to recorded amounts and any discrepancies adjusted.”
- 4.b. **Recommended Change.** OUSD(C)/CFO should substitute the term “periodic” with yearly, quarterly, or monthly.
- 4.c. **Justification.** The current requirement is vague because it allows each NAFI to independently determine the frequency with which it will perform a physical inventory of its cash. Therefore, to establish clarity and maintain uniformity among the DoD NAFIs, this section should state how often the physical inventories of cash need to be performed (yearly, quarterly or monthly).
- 5.a. **DoD FMR, Volume 13, Chapter 9, Page 6, Section 090302, Bullet D, Item 1, Letter a Error Handling.** “Corrections are made in a timely manner and reentered into the appropriate processing cycle,”
- 5.b. **Recommended Change.** The term “in a timely manner” should be substituted with the word “immediately.”
- 5.c. **Justification.** The term timely is open to interpretation, thus allowing different DoD NAFIs to determine how quickly the corrections need to be entered into the system. While conducting this audit research project, the DoD OIG came across one Military Service in which it had detected an error in its yearly 1015.15

submission, but would not report the correct information until the following year. Therefore, to prevent this type of situation from recurring, the OUSD((C)/CFO) should require the NAFIs to enter corrections into the accounting system immediately after discovering an error.

- 6.a. **DoD FMR, Volume 13, Chapter 9, Page 7, Section 090302, Bullet F, Item 3. Verifying File Data.** “The need for periodic special reviews to verify file data shall be reduced where input controls are effective and when the examination of reports routinely produced by the system can be relied upon to serve this purpose.”
- 6.b. **Recommended Change.** The OUSD((C)/CFO) should define the term “periodic” (yearly, quarterly or monthly) and should add a minimum time to which the “periodic reviews” can be reduced.
- 6.c. **Justification.** This sentence is vague because it does not state how often the initial reviews in question should be performed, and it does not explain to what extent the reviews can be reduced (once a year or once every five years). Therefore, each NAFI can determine what is the adequate frequency to conduct the reviews. In addition, if the NAFIs conclude that the controls are effective, they can be scaled back to a more appropriate range of time. As a result, this regulation does not foster uniformity among the various NAFIs and it creates the opportunity for even less uniformity by allowing the reviews to be scaled back. The regulation is also silent on how much the frequency of the reviews could be minimized. Therefore, theoretically, the reviews could potentially be postponed for multiple years. It should also be noted that in an instance where the frequency of the reviews was reduced and the controls had deteriorated, the NAFIs would run the risk of being unable to detect the deterioration of the controls in a timely manner. As a result, the accuracy of the financial information being reported will be compromised.
- 7.a. **DoD FMR, Volume 13, Chapter 9, Page 8, Section 090302, Bullet G, Items 1 & 2. Reviews and Evaluations of the System in Operation.** “Periodic reviews and tests of the accounting system shall be performed to ensure that the system and its controls and security features continue to meet user needs, perform as intended, and conform with applicable accounting standards.” “In certifying compliance with prescribed accounting principles, standards and related requirements as required by the Federal Managers’ Financial Integrity Act, transaction testing of the system in operation shall be performed.”
- 7.b. **Recommended Change.** The DoD FMR, volume 13, chapter 9 should define the term “periodic” (yearly, quarterly or monthly) and state that the system must comply with the standards published by either the Federal Accounting Standards Advisory Board (FASAB) or the Financial Accounting Standards Board (FASB), depending on which set of standards the OUSD((C)/CFO) determines the NAFIs must follow.
- 7.c. **Justification.** The existing requirement is vague and allows each NAFI to determine how often it tests the compliance of its standards. As a result, there is no uniformity across DoD in how often the NAFIs perform the test in question. DoD needs to establish testing frequency to determine whether the system is compliant with the current criteria. In addition, the OUSD((C)/CFO) needs to determine whether the NAFIs are obligated to follow the pronouncements published by either FASAB or FASB. If they are not, this sentence should

include a requirement to comply with FASAB.

- 8.a. **DoD FMR, Volume 13, Chapter 9, Page 11, Section 090302, Bullet J, Item 10.** “Usefulness. Reports produced by the accounting system shall compare current and prior-period performance, and planned performance with actual performance in a variety of ways, including on a cash, accrual, or obligational basis.”
- 8.b. **Recommended Change.** The references in this sentence to the cash and obligation basis of accounting should be eliminated.
- 8.c. **Justification.** This section gives the impression that the DoD NAFIs have the option to maintain their accounting information using the cash, accrual, or obligational basis. However, the DoD FMR, volume 13, chapter 10 states that “NAFIs are required to use the accrual method of accounting unless specifically authorized by the DoD Components to use the cash method of accounting.” Therefore, this chapter of the DoD FMR contradicts chapter 10, which states that the only two bases of accounting allowed are the accrual and the cash bases. Furthermore, AU 623 identifies “cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support” as an Other Comprehensive Basis of Accounting other than GAAP. Based on AU 623’s definition of comprehensive basis of accounting, the OIG concluded that the cash basis of accounting is not considered to be GAAP. Therefore, for the NAFIs financial reports and financial statements to comply with GAAP, they must follow the accrual basis of accounting.

## **I. DoD “FMR, Volume 13, Chapter 10, Miscellaneous,” August 1994**

- 1.a. **Page 0, Section 1003 Cash Method.** “1003 CASH METHOD OF ACCOUNTING”
- 1.b. **Recommended Change.** The Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer should remove this section from DoD FMR, volume 13, chapter 10.
- 1.c. **Justification.** The DoD FMR, volume 13, chapter 10 states: “NAFIs are required to use the accrual method of accounting unless specifically authorized by the DoD Components to use the cash method of accounting.” It should also be noted that DoD FMR, volume 13, chapter 10 adds the following statement: “This section prescribes a uniform cash method of accounting and reporting system applicable to small NAFIs. These procedures represent a single entry, cash basis system of accounting and prescribe statements which will reflect the financial condition of the various activities on a standardized basis.” As a result, the DoD OIG concluded that the DoD FMR, volume 13, chapter 10 is instructing DoD NAFIs to use the accrual method of accounting unless specifically authorized by the DoD Components to use the cash method of accounting, thus allowing DoD NAFIs to use two different types of accounting methods.

The use of two different accounting methods will affect the comparability and



consistency of the financial statements published by the DoD NAFIs. Therefore, DoD managers will be unable to compare the financial statements of NAFIs using the accrual method against NAFIs using the cash method. In addition, this section does not define the term “small NAFI,” and does not provide a methodology for measuring the size of a NAFI, thus the DoD community cannot determine whether a NAFI should either use the accrual method or the cash method. During the performance of this audit research project, the DoD OIG discovered instances where neither the accrual nor the cash method of accounting was being used. For example, the Army Civilian Morale, Welfare, and Recreation Program Group was using a single entry checkbook system.

As a result of both the review of DoD FMR, volume 13, chapter 10 and the problems with the NAFIs accounting methods DoD-wide, the DoD OIG concluded that the financial statements of all the NAFIs should use the accrual basis of accounting to achieve comparability and the consistency. Finally, it should be noted that the cash basis of accounting is considered an OCBOA, thus it does not comply with GAAP. In conclusion, it is the opinion of the DoD OIG that to maintain uniformity and to comply with GAAP, all DoD NAFIs should use the accrual basis of accounting.

**J. DoD “FMR, Volume 13; Appendix A, Accounting Procedures for the Army,” August 1994; “Appendix B, Accounting Procedures for the Air Force,” August 1994; and “Appendix C, Accounting Procedures for the Navy,” August 1994**

- 1.a. **DoD FMR, Volume 13, Appendixes A, B, and C.**
- 1.b. **Recommended Change.** Eliminate Appendixes A, B, and C in the DoD FMR, volume 13.
- 1.c. **Justification.** Each appendix prescribes accounting and financial management policy that is specific to the Army, Navy, and Air Force, for each Department that supplied the content. Therefore, this guidance as written allows the three Military Departments to conduct NAFI business inconsistently throughout DoD. In addition, during a meeting between the Policy Offices and the DoD OIG held June 27, 2006, the DoD OIG suggested that the Army, Navy, and Air Force appendices should be eliminated and a consistent format should be provided by the OUSD(C)/CFO. The OUSD(C)/CFO agreed to eliminate the three appendices.

## **Appendix F. Report Distribution**

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

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

### **Department of the Army**

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

### **Department of the Navy**

Naval Inspector General  
Auditor General, Department of the Navy

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

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

### **Combatant Command**

Inspector General, U.S. Joint Forces Command

### **Other Defense Organization**

Director, Defense Finance and Accounting Service

### **Non-Defense Federal Organization**

Government Accountability Office  
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 Homeland Security and Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Oversight and Government Reform  
House Subcommittee on Government Management, Organization, and Procurement,  
Committee on Oversight and Government Reform  
House Subcommittee on National Security and Foreign Affairs,  
Committee on Oversight and Government Reform

## **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.

Paul J. Granetto  
Patricia A. Marsh  
Barbara A. Sauls  
Joseph A. Guba  
Shanika K. Knight  
Juan Ruiz-Sanchez  
Carmen E. Pearlstein  
Wilfredo Romero-Torres  
James W. Fuller  
Deloris Luddington  
Jacqueline N. Pugh



# Inspector General Department of Defense