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Acronyms

DLA Defense Logistics Agency



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

March 20, 2007

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on the Attestation of the Defense Logistics Agency's Contingent
Legal Liability Audit Readiness Assertion (Report No. D-2007-072)

We are providing this report for information and use. No written response to this report was required. Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Amy J. Frontz at (303) 676-7392 or Mr. Anthony C. Hans at (614) 751-1400. See Appendix B for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

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

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

Department of Defense Office of Inspector General

Report No. D-2007-072

March 20, 2007

(Project No. D2006-D000FJ-0232.000)

Attestation of the Defense Logistics Agency's Contingent Legal Liability Audit Readiness Assertion

Executive Summary

Who Should Read This Report and Why? Personnel who prepare and rely on the Defense Logistics Agency financial statements should read this report. It discusses the financial reporting of Defense Logistics Agency contingent legal liabilities.

Background. The Defense Logistics Agency is the largest combat support agency in DoD, providing worldwide logistics support in both peacetime and wartime to the military services as well as several civilian agencies and foreign countries. Contingent legal liabilities include existing conditions, situations, or sets of circumstances involving uncertainty as to a possible loss to an entity.

The Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended by No. 12, "Recognition of Contingent Liabilities Arising from Litigation," classifies the likelihood of a loss as "probable" (more likely than not to occur), "reasonably possible" (more than "remote" but less than "probable"), or "remote" (slight chance of occurring). The classification determines whether contingent legal liabilities are recorded, disclosed, or not reported in the financial statements.

The Defense Logistics Agency's loss contingencies arise primarily from litigation, claims, and assessments for events such as property damage, environmental claims, and contractual disputes. The responsible legal office attorney assigns a monetary value to each case based on the merits of the legal matter and the attorney's professional judgment. At the end of each reporting period, the total value of all probable cases is reported as a liability, and the total value of all reasonably possible cases is disclosed in the notes to the financial statements.

On December 29, 2005, the Defense Logistics Agency asserted that its contingent legal liability balance sheet line item was ready for audit. Based on this assertion, the Office of the Under Secretary of Defense (Comptroller) Deputy Chief Financial Officer requested that we perform an assessment and audit. We performed it as an examination engagement.

Results. In our opinion, management's assertion that the Defense Logistics Agency contingent legal liabilities line item is fairly presented and ready for audit, presents, in all material respects, an accurate representation as of September 30, 2006 (see the enclosed Independent Auditor's Report for details).

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

March 20, 2007

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Independent Auditors Report on the Defense Logistics Agency Contingent Legal Liabilities Audit Readiness Assertion (Report No. D-2007-072)

We have examined management's assertion dated December 29, 2005, that the Defense Logistics Agency contingent legal liabilities line item is fairly presented in accordance with DoD Financial Improvement Initiative Business Rules and is ready for audit. As documented in the engagement memorandum dated August 28, 2006, the Defense Logistics Agency was required to: fairly present its contingent legal liabilities in conformity with generally accepted accounting principles; comply with laws and regulations; establish and maintain adequate internal controls over financial reports; and provide auditors with timely information required to complete the engagement. Our responsibility is to express an opinion on management's assertion that its contingent legal liabilities line item is fairly presented and ready for audit. This includes determining whether evidential matter exists to support the transactions that constitute the value reported in the balance sheet.

Our examination was conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants and generally accepted government auditing standards as stated in the Government Accountability Office's "Government Auditing Standards." These standards require examining, on a test basis, evidence supporting management's assertion about the fair presentation and audit readiness of the contingent legal liabilities, and performing other procedures deemed necessary. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertion that the Defense Logistics Agency contingent legal liabilities line item is fairly presented and ready for audit presents, in all material respects, an accurate representation as of September 30, 2006. We were unable to rely on the controls of the Defense Logistics Agency Case Management System, which is used to track and report contingent legal liabilities, because it is not certified and accredited in accordance with DoD requirements and has not undergone an audit in accordance with the Government Accountability Office "Financial Information Security Controls Audit Manual." However, we mitigated the related risks by reviewing all of the cases supporting the line item balance and by performing additional procedures.

This report is intended solely for the information of the Director, Defense Logistics Agency, and is not intended to be and should not be used by anyone other than the specified party. However, this report is a matter of public record and its distribution is not limited.

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

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

Appendix A. Scope and Methodology

We performed this examination from July 2006 through March 2007. The examination was performed in accordance with generally accepted government auditing standards, which reflect the financial audit and attestation standards established by the American Institute of Certified Public Accountants, as implemented by the Government Accountability Office/President's Council on Integrity and Efficiency "Financial Audit Manual." For purposes of this engagement, we attested to the audit readiness of the Defense Logistics Agency (DLA) contingent legal liabilities.

We performed the examination at DLA Headquarters and field locations, including the Defense Distribution Center, the Defense Reutilization and Marketing Service, the Defense Supply Center Columbus, the Defense Supply Center Philadelphia, and the Defense Supply Center Richmond. At these locations, we interviewed DLA financial management and legal officials involved in the financial reporting of contingent legal liabilities. We also reviewed the supporting documentation of a number of pending cases.

We reviewed applicable generally accepted accounting principles including: Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," September 1995, as amended by Statement of Federal Financial Accounting Standards No. 12, "Recognition of Contingent Liabilities Arising from Litigation," December 1998. These standards classify the likelihood of a loss as "probable" (more likely than not to occur), "reasonably possible" (more than "remote" but less than "probable"), or "remote" (slight chance of occurring). The classification determines whether contingent legal liabilities are recorded, disclosed, or not reported in the financial statements.

We analyzed internal controls associated with the legal cases reported in the DLA Case Management System for the end of the third quarter of FY 2006. We reviewed 12 cases categorized as "probable" and 9 cases categorized as "reasonably possible." We also judgmentally selected cases categorized as "remote" and "unable to determine" and interviewed contracting officials in order to test the completeness of the contingent legal liability line item.

We conducted substantive testing on 100 percent of the 11 cases categorized as "probable" and the 12 cases categorized as "reasonably possible" as of September 30, 2006. The estimated liability of the "probable" cases ranged from \$10.8 million to \$18.5 million. The estimated liability of the "reasonably possible" cases ranged from \$27 thousand to \$11.3 million.

Use of Computer-Processed Data. DLA contingent legal liabilities are reported and tracked in the DLA Case Management System. The DLA Case Management System is a stand-alone management information system used by DLA General Counsel to track data such as case number, dates when a case was opened and closed, and the likelihood of cash outflow. At the end of each reporting period, a DLA Case Management System report is used to support a journal voucher for the contingent legal liability value reported on the DLA financial statements. There has never been a Government Accountability Office "Financial Information

Security Controls Audit Manual” audit conducted on the DLA Case Management System. In addition, the DLA Case Management System is not certified and accredited in accordance with DoD Instruction 5200.4 "DoD Information Technology Security Certification and Accreditation Process" December 30, 1997, or the “DoD Information Assurance Certification and Accreditation Process,” July 6, 2006. Therefore, we did not rely on the information system controls and reviewed 100 percent of the cases supporting the contingent legal liability line item balance.

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

Prior Coverage

No prior coverage has been conducted on the financial reporting of DLA contingent legal liabilities during the last 5 years.

Appendix B. Report Distribution

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Deputy Chief Financial Officer
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Director, Program Analysis and Evaluation

Department of the Army

Auditor General, Department of the Army

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Department of the Air Force

Auditor General, Department of the Air Force

Combatant Command

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Director, Defense Logistics Agency

Non-Defense Federal Organizations and Individuals

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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.

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Inspector General Department of Defense