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INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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May 4, 2007

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) / CHIEF
FINANCIAL OFFICER
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL
MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE LOGISTICS AGENCY
DIRECTOR, DEFENSE COMMISSARY AGENCY
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Memorandum Report on Assessment of Department of Defense Accounts Payable
Compliance with Generally Accepted Accounting Principles
(Report No. D-2007-091)

We performed audit work to assess the ability of DoD's accounting systems to process, account for, and report Accounts Payable in accordance with generally accepted accounting principles during the period from December 2005 through November 2006. We are providing this memorandum report for your information and use. No written response to this memorandum report is required.

We appreciate the courtesies extended to our audit staff. Questions should be directed to Ms. Amy Frontz at (303) 676-7392 (DSN 926-7392) or Mr. M. James Herbic at (303) 676-3280 (DSN 926-3280). The team members are listed on the final page of this memorandum report.

What We Found

This memorandum contains information on the inability of the Department of Defense to identify, process, record, and report Accounts Payable in accordance with generally accepted accounting principles because of material internal control deficiencies. DoD management has not implemented control activities or internal controls over financial reporting related to Accounts Payable that effectively correct or compensate for the following control deficiencies.

- Components are unable to identify intragovernmental transactions by customer; the Components cannot assure they are properly eliminating or disclosing all intragovernmental Accounts Payable in the financial statements; and, the Components adjust their non-DoD intragovernmental Accounts Payable amounts to agree to seller-side balances for financial statement reporting. As a result, reported Accounts Payable balances do not agree with transaction detail in supporting accounting systems.
- The actual or constructive receipt or acceptance of goods and services should be the basis for recording Accounts Payable. Internal controls are not adequate to ensure the Components always follow this policy.
- Procedures for accounting recognition of unbilled purchases of goods and services are not adequate.

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- DoD records and reports Accounts Payable balances in its financial statements without reconciling to transactional detail in supporting accounting systems.
 - Aged Accounts Payable are not reviewed to identify and resolve balances that may no longer be valid or warrant investigation.

DoD will not be able to report Accounts Payable in compliance with generally accepted accounting principles (GAAP) without correcting these material internal control weaknesses.

What We Did

We assessed the design and operation of DoD internal controls for both Accounts Payable (a) Intragovernmental (Federal) and (b) Public (non-Federal). We considered applicable control activities and internal controls over financial reporting used by the Departments of the Army, Navy, and Air Force, the Defense Finance and Accounting Service (DFAS), the Defense Commissary Agency, and the Defense Logistics Agency. Based on the first quarter FY 2006 reported amounts, Accounts Payable for these Components were more than 70 and 64 percent of the Federal and non-Federal amounts, respectively. We made site visits to various DFAS and military Department financial management office locations to conduct interviews and to test controls. We identified previously reported Accounts Payable deficiencies and inquired with responsible management officials as to the status of improvements and corrections.

During this project, the annual Chief Financial Officer (CFO) financial statement reporting and audit cycle occurred. In connection with our audits of their financial statements, DoD financial management officials from each of the Military Departments made written representations to us concerning their internal controls. Their representations gave us indications of significant risks that the Accounts Payable disclosures were materially misstated in the financial statements. DoD reported certain Accounts Payable deficiencies as overall material weaknesses and as an overall systemic weakness in its Performance and Accountability Report FY 2006 with which we concur. This memorandum provides additional information and examples found during our assessment regarding the Accounts Payable overall systemic weakness. We will not issue a separate formal audit report.

Examples of Noncompliance with GAAP

i. **Management Representations.** According to the FY 2006 CFO audit representations made by the Deputy Assistant Secretary of the Army (Financial Operations), the Assistant Secretary of the Navy (Financial Management and Comptroller), and the Principal Deputy Assistant Secretary of the Air Force (Financial Management), these Components cannot always accurately identify all intragovernmental transactions and balances by customer. Therefore, there is no assurance for financial reporting that DoD can identify, eliminate, or disclose all transactions occurring between entities within DoD or between DoD and other Federal agencies. The Components also acknowledged that they adjust their intragovernmental Accounts Payable amounts to agree to balances provided by their seller-side trading partners. Adjustments to agree with non-DOD trading partners are not allowed by the DoD Financial Management Regulation. Accordingly, intragovernmental Accounts Payable balances reported in the Components' financial statements do not agree with transaction detail in supporting accounting systems. The Navy acknowledged that General Fund Intragovernmental Accounts Payable (such as fuel payables and non-Power Track transportation) and Accounts Payable to the Public for the General Fund are not being recorded timely, completely, or accurately. As a result, existing accounting procedures create abnormal balances in these financial statement line items that are not resolved. Until the Components correct

these deficiencies, there is a significant risk that the DoD Accounts Payable disclosure in its financial statements is materially misstated.

ii. Accounts Payable for Air Force Travel Expenses. Air Force accounting systems recognize employee travel expenses for accounting purposes before they occur. When an authorized official approves a travel authorization, system processing recognizes an Accounts Payable the next day. This recognition is premature as the goods and services authorized have not been received. The accounting recognition of undelivered goods and services results in reporting Accounts Payable balances in its financial statements that do not reconcile to supporting Accounts Payable systems.

iii. Standard Accounting Budgeting Reporting System (SABRS). The Marine Corp SABRS system processes and accounts for Accounts Payable. Accurate dates for the receipt of goods and services are available in the Wide Area Workflow interface system. However, SABRS does not use these dates in recognizing Accounts Payable. This results in recording Accounts Payable at a date later than the actual or constructive receipts of purchased goods and services, which is not in compliance with GAAP. After the completion of our fieldwork, DFAS advised us that it implemented a system change request to allow SABRS to receive the correct dates for Accounts Payable recognition. Although we did not verify this system change, we commend the quick action of DFAS to improve the Marine Corps' compliance with GAAP.

iv. Mechanization of Contract Accounting System (MOCAS). The MOCAS system is a contract payment system that processes a significant dollar volume of transactions for all major DoD Components. Its internal controls governing the processing of payment entitlement and the related disbursement controls delay the recognition of Accounts Payable beyond the date goods or services are received. Therefore, Accounts Payable balances reported in the DoD financial statements do not include contract payables that should be recognized in accordance with GAAP and these amounts may be material. DFAS is currently engaged in a project to improve the accuracy of its estimates of the unrecognized Accounts Payable related to the MOCAS system.

v. Standard Army Finance Information System (STANFINS) and Standard Operation and Maintenance Army Research and Development System (SOMARDS). The Army uses STANFINS and SOMARDS to process and account for Accounts Payable. The Army's disbursing system, STANFINS Redesign Subsystem One, transmits disbursement transaction information to these accounting systems. When the transmitted disbursement information does not match an existing Accounts Payable in the accounting systems, the transmitted information is used by these systems to concurrently recognize an Accounts Payable and its liquidation. Recording Accounts Payable concurrently with recording the related disbursements indicates the Accounts Payable are not recognized on a timely basis. In the alternative, the original Accounts Payable that are not matched to the disbursements remain unliquidated and overstated after recording the disbursements. DFAS officials discussed this condition in connection with vendor payments and acknowledged that Accounts Payable recognition and reporting are not in compliance with GAAP. No effective compensating internal controls have been designed to overcome this deficiency.

vi. Accounts Payable Related to Closed Appropriations. The Air Force financial statements include past due Accounts Payable attributable to closed appropriations. These amounts may reflect Accounts Payable that no longer exist and are not a valid liability. Accounting personnel do not make regular reviews to identify such balances and determine their validity. When Accounts Payable related to closed appropriations are not valid, misstatements occur in the financial statement balances for Accounts Payable, status of obligations, and other reported amounts. Without an internal control to identify and resolve such balances, there is an increased risk that such misstatements exist in the Air Force financial statements.

vii. Defense Logistics Agency (DLA). The Defense Energy Supply Center (DESC) began a review in January 2006 because it recognized an unusual build up in its Accounts Payable balances. At the time of our audit, a review of \$55.1 million of such Accounts Payable resulted in removing \$42.3 million of invalid balances. Also, the DLA Defense Fuel Automated Management System processes Accounts Payable for the purchase of various services. Its prevalidation process recognizes Accounts Payable for DLA financial statement reporting prior to the actual date of receipt or acceptance of services. DLA has not implemented internal controls to correct or compensate for these weaknesses in recognizing Accounts Payable on a timely basis. .

In addition, the Business Systems Modernization software processes and accounts for payments of billings related to construction projects for DLA. Delays in Accounts Payable recognition for these billings until they are matched to a valid purchase order and obligation results in unrecorded Accounts Payable at financial statement reporting dates. Until DLA designs and implements internal controls to prevent the accumulation of significant amounts of invalid Accounts Payable in DESC records, recognize Accounts Payable for construction projects on a timely basis, and prevent the premature recognition of Accounts Payable for purchased services, there is a significant risk that its financial statements are misstated.

Conclusion

Until corrected, the control deficiencies discussed in this memorandum result in more than a remote likelihood that a material misstatement in the financial statements of DoD could occur and not be detected. They prevent DoD from having assurance that the Accounts Payable balances in its financial statements are reported in accordance with generally accepted accounting principles. Because of the likelihood of material misstatement, DoD must continue to report its material weakness in internal controls for Accounts Payable until it makes the necessary improvements. DoD managers will not be able to obtain a cost-effective audit of the Department's financial statements or an individual line item, such as Accounts Payable, until they implement appropriate internal controls.

By direction of the Deputy Inspector General for Auditing:



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

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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