

# Inspector General

United States  
Department of Defense



Reporting of Contract Financing Interim  
Payments on the DoD Financial Statements

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### **Acronyms**

CLRS	Contract Load Reconciliation System
DFAS	Defense Finance and Accounting Service
FAR	Federal Acquisition Regulation
GAFS-R	General Accounting and Reporting System-Rehost
MILDEPs	Military Departments
MOCAS	Mechanization of Contract Administration Services
OSD(C)/CFO	Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer
PP&E	Property, Plant, and Equipment
RDT&E	Research, Development, Test and Evaluation
SFFAS	Statement of Federal Financial Accounting Standard
SOMARDS	Standard Operation and Maintenance Army Research and Development System
STARS-FL	Standard Accounting and Reporting System Field Level
STARS-HCM	Standard Accounting and Reporting System Headquarters Command Module
WIP	Work-in-Process



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January 31, 2008

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

SUBJECT: Report on Reporting of Contract Financing Interim Payments on the DoD  
Financial Statements (Report No. D-2008-042)

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

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense (Comptroller)/Chief Financial Officer's comments were not responsive. We request additional comments on Recommendations 1, 2, 3, and 4 by March 2, 2008.

We request that management provide comments that conform to the requirements of DoD Directive 7650.3. If possible, please send management comments in electronic format (Adobe Acrobat file only) to [AUDcolu@dodig.mil](mailto:AUDcolu@dodig.mil). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to James L. Kornides at (614) 751-1400 ext. 211 or Mr. Mark Starinsky at (614) 751-1400 ext. 231. See Appendix D for the report distribution. The team members are listed in the inside back cover.

*Patricia A. Marsh*  
Patricia A. Marsh, CPA  
Assistant Inspector General and Director  
Defense Financial Auditing Service



## **Department of Defense Office of Inspector General**

**Report No. D-2008-042**

**January 31, 2008**

(Project No. D2007-D000FJ-0058.000)

### **Reporting of Contract Financing Interim Payments on the DoD Financial Statements**

#### **Executive Summary**

**Who Should Read This Report and Why?** DoD personnel involved with preparing the DoD financial statements should read this report. It discusses the current process for recording and accounting for contract financing interim payments.

**Background.** The Federal Acquisition Regulation defines contract financing payments as payments to contractors prior to acceptance of supplies or services. The Federal Acquisition Regulation allows contractors to submit payment requests for contract financing interim payments up to twice per month. This report focuses on the accounting and presentation of interim payments on cost reimbursement contracts for non-services, hereafter referred to as contract financing interim payments. The Military Departments use contract financing interim payments to finance the research, development, and acquisition of DoD weapon system items such as missiles, aircraft, and ships. The Defense Finance and Accounting Service Columbus provided data that show that the contract service system disbursed \$82.2 billion of contract financing interim payments from FY 2004 through FY 2006.

**Results.** Our judgmental sample of \$33.16 billion of contract financing interim payments showed that DoD did not report \$10.41 billion of the payments correctly as Property, Plant, and Equipment Construction Work-in-Process. It did report \$20.61 billion correctly as expenses. The remaining \$2.14 billion should have been reported as Property, Plant, and Equipment and was being reviewed as part of a DoD Office of Inspector General Military Equipment audit. Also, DoD did not present any of the \$33.16 billion of contract financing interim payments in the Other Assets on the Balance Sheet as it claimed in the footnotes to the financial statements. As a result, DoD understated its Property, Plant, and Equipment Construction Work-in-Process by about \$10.41 billion and overstated its expenses by a corresponding amount. There is also a likelihood that expenses will be understated in the period in which the final asset is delivered. In addition, DoD and the Military Departments materially misrepresented the Other Assets Balance Sheet account. See the Finding section of the report for the detailed recommendations. The internal controls were not adequate. We identified a material internal control weakness in the reporting of contract financing interim payments.

**Management Comments and Audit Response.** The Deputy Chief Financial Officer nonconcurred that the quarterly financial statement note disclosure checklist and the DoD Regulation 7000.14-R, "DoD Financial Management Regulation," policy for recording and reporting contract financing interim payments required revision. He also disagreed that contract financing interim payments met the definition of Property, Plant, and Equipment but stated that they do represent assets. He agreed to revise

DoD Regulation 7000.14-R so that it included consistent policy for capitalizing Research, Development, Test, and Evaluation costs.

We disagree that current policy does not require revision. Current accounting policy for contract financing interim payments resulted in a misclassification of assets and expenses, a material understatement of the Construction Work-in-Process balance, and material misrepresentations in Note 1R, which could distort future financial information. We request that the Deputy Chief Financial Officer provide comments on the final report by March 2, 2008. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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## Background

The Federal Acquisition Regulation (FAR) defines contract financing payments as payments to contractors prior to acceptance of supplies or services. In some instances, the FAR considers interim payments to be contract financing. The FAR categorizes interim payments on cost reimbursement contracts for non-services as contract financing payments and categorizes interim payments on cost reimbursement contracts for services as standard invoices. The FAR allows contractors to submit payment requests for contract financing interim payments up to twice per month. This report focuses on the accounting and presentation of interim payments on cost reimbursement contracts for non-services, hereafter referred to as contract financing interim payments.

The FAR also considers progress payments based on cost, performance-based payments, and commercial financing interim payments to be contract financing. The DoD Office of Inspector General discussed the financial statement presentation of these types of contract financing payments in a prior audit report. For information on the results of that audit, see Appendix C.

The Military Departments use contract financing interim payments to finance the research, development, and acquisition of DoD weapon system items such as missiles, aircraft, and ships.

**Scope of Interim Payments.** The Defense Contract Management Agency generally administered and approved contract financing interim payments on DoD contracts, and the Defense Finance and Accounting Service (DFAS) was responsible for payment. The DFAS Columbus Center disbursed \$175.5 billion on 1.3 million interim payments transactions to Defense contractors during FY 2004 through FY 2006. Based on DFAS data, 371,124 transactions totaling \$82.2 billion were contract financing interim payments.

**FY 2006 Performance and Accountability Report Information.** The DoD Performance and Accountability Report for FY 2006 contained information that indicated that DoD considered its contract financing interim payments to be Other Assets as long as DoD did not report the payments elsewhere on the Balance Sheet. As of September 30, 2006, the Military Departments reported \$24.6 billion in outstanding contract financing in the Other Assets section of the Balance Sheet.

## Objectives

Our audit objective was to assess whether the Department of Defense is accurately recording and accounting for interim payments on cost reimbursement contracts (other than service contracts) in the DoD financial statements. See Appendix A for a discussion of the scope and methodology and for prior coverage related to the objectives.

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## **Review of Internal Controls**

We identified material internal control weaknesses for DoD as defined by DoD Instruction 5010.40, "Manager's Internal Control (MIC) Program Procedures," January 4, 2006. DoD did not have adequate internal controls for recording and presenting contract financing interim payments. Implementing the recommendations will improve DoD controls for recording and presenting contract financing interim payments in the DoD financial statements. A copy of the report will be provided to the senior official responsible for internal controls in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer (OSD[C]/CFO).

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## DoD Reporting of Contract Financing Interim Payments

DoD did not properly report \$10.41 billion of the \$33.16 billion sample payments as Property, Plant, and Equipment (PP&E) Construction Work-in-Process (WIP). DoD reported \$20.61 billion correctly as expenses. We did not review the remaining \$2.14 billion for compliance with Federal Accounting Standards. Also, DoD did not present any of the \$33.16 billion of contract financing interim payments in the Other Assets account on the Balance Sheet as it claimed in the footnotes to the financial statements. This occurred because the OSD(C)/CFO issued inadequate policy for recording and presenting these financing payments. As a result, DoD understated its PP&E Construction WIP information by about \$10.41 billion and overstated its expenses by a corresponding amount. There is also the likelihood that expenses will be understated in the period in which the final asset is delivered. Additionally, DoD and the Military Departments (MILDEPs) materially misrepresented the Other Assets Balance Sheet account.

### Reporting Interim Payments

DoD did not report its contract financing interim payments in accordance with Federal accounting policy. Specifically, we identified \$10.41 billion of contract financing interim payments from our audit sample that DFAS and the MILDEPs should have recorded in Construction WIP asset accounts. Additionally, DFAS and the MILDEPs inappropriately classified the payments as expenses.

**Audit Sample.** DFAS Columbus provided a database of interim payments that it disbursed through the Mechanization of Contract Administration Services (MOCAS) system from October 1, 2003, through September 30, 2006. To perform our tests, we selected a judgmental sample of 29 contracts that had a high dollar value of contract financing interim payments. Most of the sample contracts that we selected were for the development or purchase of major DoD weapons programs including the Trident II D-5 Fleet Ballistic Missile, the F-35 Joint Strike Fighter, and the Littoral Combat Ship.

**Recognizing Assets Purchased with Interim Payments.** For 15 of the 29 sample contracts, DoD did not properly report the contract financing interim payments, totaling \$10.41 billion, in a Construction WIP account on the Balance Sheet. These disbursements met the requirements for capitalization (which means to record as an asset on the Balance Sheet) as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 6 because they were used to purchase PP&E end items that had not yet been delivered.

SFFAS No. 6 states that all General PP&E should be recorded at cost. Cost includes all costs incurred to bring the PP&E to a form and location suitable for its intended use. According to SFFAS No. 6, cost may also include engineering, architectural, and any other outside services for designs, plans, specification, and

survey. SFFAS No. 6 further states that in the case of constructed PP&E, the PP&E should be recorded as Construction Work-in-Process until it is placed in service, at which time the balance should be transferred to General PP&E. Based on these criteria, DoD should have classified the \$10.41 billion of contract financing interim payments as Construction WIP. Additionally, the Statement of Federal Financial Accounting Concepts No. 1, "Objectives of Federal Financial Reporting," September 2, 1993, states that transactions pertaining to the future are recognized on the Balance Sheet as assets and liabilities. Because DoD will use the assets it was purchasing in the future, DoD should have reported these disbursements on the Balance Sheet as a Construction WIP asset.

The 15 sample contracts were related to Military equipment purchases, not real property. DoD did not report any Military equipment Construction WIP balances for the contract financing interim payments in our sample. In Footnote 10 of the FY 2006 Performance and Accountability Report, DoD and the MILDEPs reported nine subaccounts for the General PP&E account. DoD also reported \$12.8 billion in Construction-in-Progress for the MILDEPs for real property construction

Table 1 shows the sample contracts and associated disbursement amounts that DoD should have reported in the Construction WIP account but did not. The purchases were for property and equipment and included software and major end items that were under construction.

<b>Table 1. Sample Contracts that Included a Construction WIP Balance</b> (in millions)		
<u>Sample Number</u>	<u>Major End Item Acquisition</u>	<u>Disbursement Amount</u>
2	Trident II	\$207.1
3	Trident II	134.6
4	Trident II	53.6
9	RIM-161 SM-3	530.5
13	C-5 RERP	685.5
14	Software for Aegis Ballistic Missile Defense	550.3
16	Multi-Platform Radar Technology Insertion Program	597.8
17	C-130 AMP	584.3
19	Littoral Combat Ship	327.7
21	Excalibur Precision Extended Range Artillery Projectile	260.4
22	F-135 Propulsion System and Engine Interchangeable	2,450.2
23	Advanced Extremely High Frequency	1,990.3
26	Mobile User Objective System	671.3
27	Presidential Helicopter Replacement	598.8
29	DD(X) Design	765.8
<b>Total</b>		<b>\$10,408.2*</b>
* The difference between the total and the \$10.41 billion discussed in the body of the report is the result of rounding.		

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**Expenses.** Instead of reporting the \$10.41 billion of contract financing interim payments as PP&E Construction WIP, DoD reported them as an expense on the Statement of Net Cost.

SFFAS No. 1, “Accounting for Selected Assets and Liabilities,” March 30, 1993, states that an expense is an outflow of assets during a period in which the benefits from which do not extend beyond the present operating period. In the case of contract financing interim payments that are not expenses, the benefits do extend beyond the current accounting period. Specifically, the benefits obtained from these disbursements will extend beyond the present period because DoD was purchasing Military equipment that it will report on the Balance Sheet in future periods. Therefore, these disbursements did not meet the definition of an expense and should not have been included in the respective FYs Statement of Net Cost.

Table 2 shows the breakout of the 3 years of disbursements that DoD posted to an expense account. DoD should have posted them to an asset Construction WIP account.

**Table 2. Sample Amount Expensed by Fiscal Year**  
(in billions)

<u>Fiscal Year</u>	<u>Disbursement Amount</u>
2004	\$2.50
2005	3.11
2006	4.79
<b>Total</b>	<b>\$10.40*</b>

\* The difference between the total and the \$10.41 billion discussed in the body of the report is the result of rounding.

## Presenting Interim Payments

DoD did not accurately disclose how it presented interim payments on the financial statements. Specifically, DoD and the MILDEPs stated in Note 1R Other Assets of their FY 2006 Financial Statements that Other Assets includes contract financing payments that they did not report elsewhere on the Department’s Balance Sheet. The financial statements also indicated that contract financing payments may include interim payments under certain cost-reimbursement contracts.

This disclosure was not accurate. DoD reported contract financing interim payments as expenses on the Statement of Net Cost and, in general, did not report them on the Balance Sheet at all. For our \$33.16 billion sample interim payments, DoD reported the majority of the payments as expenses, with the possible exception of \$2.14 billion, which might be part of the Military Equipment balance. We did not perform testing to verify if the \$2.14 billion that should have been reported as Property, Plant, and Equipment was properly

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reported as Property, Plant, and Equipment for Military Equipment because another DoD Office of Inspector General audit team was in the process of reviewing the assertion package for Military Equipment Valuation. DoD and the MILDEPs did not report any of the \$33.2 billion as contract financing in the Other Assets account on the Balance Sheet as they claimed.

## Adequacy of DoD Policy

This misclassification and inaccurate presentation of contract financing interim payments occurred because the OSD(C)/CFO did not provide adequate guidance for recording and presenting contract financing interim payments on the financial statements. We reported similar results in a prior audit on the presentation of progress payments, performance based payments, and commercial financing interim payments. See Appendix C for more information on the prior contract financing audit. In addition, the OSD(C)/CFO did not have adequate and consistent policy on when costs should begin to be capitalized, especially in relation to research and development costs.

**DoD Contract Financing Interim Payment Guidance.** The OSD(C)/CFO provided improper guidance on how contract financing interim payments should be recorded. Beginning in FY 2006, the OSD(C)/CFO provided interim guidance to the MILDEPs to report and present contract financing interim payments in the Other Assets balance as contract financing payments.

This interim guidance was not in accordance with Federal Accounting Standards. Based on Federal Accounting Standards, DoD should have:

- expensed \$20.61 billion of the \$33.16 billion sample,
- reported \$2.14 billion as Military Equipment, and
- reported \$10.41 billion under the PP&E account as Construction WIP.

To report and present contract financing interim payments accurately on the financial statements, DoD must rescind the interim guidance that requires reporting all contract financing interim payments as Other Assets.

**DoD Construction WIP Guidance.** In addition to the interim guidance, the OSD(C)/CFO provided conflicting and improper guidance on reporting Construction WIP amounts for Military Equipment PP&E in DoD Regulation 7000.14-R, “DoD Financial Management Regulation,” volume 4, chapter 6, “Property, Plant and Equipment,” July 2006.

Specifically, DoD Regulation 7000.14-R volume 4, chapter 6, section 060106 G, states that entities can accumulate engineering and design costs in the Construction-in-Progress account. Many of our sample contract financing interim payments are engineering and design costs and, therefore, could be reported in the Construction-in-Progress account. However, in DoD Regulation 7000.14-R volume 4, chapter 6, section 060202 B, the DoD Comptroller states that DoD

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should use the Construction-in-Progress account (Account 1720) to accumulate the costs of real property construction projects. None of our sample contracts were for the construction real property. Therefore, the DoD Regulation 7000.14-R guidance did not specifically require or allow the posting of contract financing interim payments to the Construction-in-Progress account.

To resolve this issue, the OSD(C)/CFO needs to either allow Military Equipment Construction WIP to be reported in the Construction-in-Progress account or create a new Construction WIP account for Military Equipment.

**DoD Research and Development Cost Guidance.** Of the 29 sample contracts, 12 included Military equipment Construction WIP items funded through Research, Development, Test, and Evaluation (RDT&E) appropriations. Despite the widespread use of these appropriations for weapons system design and development, the OSD(C)/CFO did not provide the reporting entities specific and consistent guidance to determine whether they should capitalize or expense contract financing interim payments made with RDT&E funds. DoD reporting entities needed better guidance to report their Military Equipment Construction WIP balances accurately.

The DoD Regulation 7000.14-R guidance for reporting research and development costs was inconsistent and unclear. Specifically, DoD Regulation 7000.14-R volume 4, chapter 17, “Expenses and Miscellaneous Items,” section 170202(A), June 2000, states that expenses incurred for research and development must be recorded and reported as an expense in the period incurred. However, DoD Regulation 7000.14-R volume 4, chapter 6, “Property, Plant, and Equipment,” section 060201(B), July 2006, states that the recorded cost or value must include all amounts paid to bring the property to its form and location suitable for its intended use. Examples of these costs include engineering, architectural, and other outside services for designs, plans, specification, and survey. DoD Regulation 7000.14-R further states in section 060103(A)(8) that General PP&E should exclude items that the agency should expense as RDT&E costs unless they are associated with the development of an end item that is produced for operational use. However, DoD Regulation 7000.14-R does not provide additional guidance on how to determine whether the research and development is related to a functional end item.

Because of the lack of proper guidance for recording and presenting interim payments, it was understandable how DFAS and the MILDEPs continued to report all contract financing interim payments as expenses unless the OSD(C)/CFO specifically stated that the payments should be reported as Military Equipment.

## **Effect of Misclassification**

Because of the misclassification, DoD and the MILDEPs materially understated their FY 2006 PP&E Construction WIP account balance by at least \$10.41 billion. This understatement represented 81 percent of the reported Construction-in-Progress balance for the three services.

Table 3 shows the reported balances and percent not reported in each MILDEP.

<b>Table 3. FY 2006 Balances</b> (in billions)			
<u>Service</u>	PP&E Construction- in-Progress	PP&E Construction WIP Not Reported	Percent Not Reported
Army	\$7.1	\$0.3	4.2
Navy	2.4	5.1	212.5
Air Force	3.3	5.0	151.5
<b>Total</b>	<b>\$12.8</b>	<b>\$10.4*</b>	<b>81.3</b>
* The difference between the total and the \$10.41 billion discussed in the body of the report is the result of rounding.			

Because DoD also overstated expenses by at least \$2.50 to \$4.79 billion for FYs 2004 through 2006 (see Table 3), DoD will understate expenses for that accounting period when it reports the cost of the delivered assets. Specifically, DoD accountants have been debiting the Military Equipment balance for the entire purchase amount and making a corresponding credit to expenses, even though it recorded the disbursements as expenses in prior periods.

DoD materially misrepresented the contract financing balance in the Other Assets account when it disclosed that the contract financing interim payments were included in the balance. DoD's contention that it included all of contract financing interim payments in the Other Assets account is not accurate. If the sample contract financing interim payments were included in the reported Outstanding Contract Financing balance, the balance would be increased by at least \$33.16 billion. We do not agree with reporting all contract financing payments in the Other Assets account. Our prior audit of the presentation of progress payments, performance based payments, and commercial financing interim payments showed that these payments were predominately financing Military Equipment purchases. Appendix C contains more information about the audit results.

Table 4 shows the Outstanding Contract Financing balance and the total value of the contract financing interim payments disbursements for FY 2004 through FY 2006.



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<b>Table 4. FY 2006 Outstanding Contract Financing Balances</b> (in billions)		
<u>Service</u>	<u>Report Balance</u>	<u>Sample Contract Financing Interim Payments</u>
Army	\$5.3	\$6.68
Navy	8.2	13.75
Air Force	11.1	12.73
<b>Total</b>	<b>\$24.6</b>	<b>\$33.16</b>

The misstatements to PP&E Construction WIP and expenses and the misrepresentation of the Outstanding Contract Financing balance identified in this report do not necessarily represent the entire contract financing interim payment-related misstatements that existed. The judgmental sample included only 40.3 percent of the entire contract financing interim payments universe provided by DFAS Columbus. Therefore, additional misstatements of these balances may have occurred. Without corrective actions, DoD will continue to materially misstate and misrepresent contract financing interim payments on the DoD financial statements.

## Recommendations, Management Comments, and Audit Response

**We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer:**

**1. Rescind the interim guidance checklist that directed its reporting entities to report contract financing interim payments in the Outstanding Contract Financing balance.**

**Management Comments.** The Deputy Chief Financial Officer nonconcurred and stated that the quarterly financial statement note disclosure checklist accurately reflects DoD policy for reporting contract financing interim payments in the Department's consolidated Balance Sheet.

**Audit Response.** The Deputy Chief Financial Officer comments are not responsive. The quarterly financial statement note disclosure checklist does not properly address the relevant Federal accounting requirements for reporting contract financing interim payments on the DoD Balance Sheet and, as a result, assets and expenses were not accurately reported. Specifically, the quarterly guidance simply requires that contract financing payments be reported as Other Assets. However, the guidance does not address how the Military Departments and DFAS should identify contract financing interim payments and whether they

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must be reported on the Balance Sheet or expensed. The quarterly financial statement note disclosure checklist did not ensure that any contract financing interim payments were reported on the Balance Sheet. DFAS did not include any of them in the Other Asset account. Additionally, the quarterly policy does not include guidance for deciding whether contract financing interim payments relate to an asset that should be capitalized or relate to an expense item. These significant gaps in the quarterly policy resulted in material departures from generally accepted accounting principles and material misstatements in the Construction WIP account and the footnotes to the financial statements. Specifically, DoD reported about \$10.41 billion in assets and disclosed that all contract financing payments were included in the Outstanding Contract Financing balance when they were not. We request that the Deputy Chief Financial Officer reconsider his position and provide additional comments.

**2. Revise DoD Regulation 7000.15-R, “DoD Financial Management Regulation,” to include guidance to record contract financing interim payments as Construction Work-in-Process or expenses.**

**Management Comments.** The Deputy Chief Financial Officer nonconcurred and stated that contract financing interim payments do not meet the SFFAS definition of PP&E. He stated that contract financing payments are cash disbursements made to a contractor to finance the performance under the contract prior to acceptance of goods or services. He also stated that reporting cash disbursements as PP&E on the DoD Balance Sheet would mislead readers and reduce the usefulness and clarity of the information reported. The Deputy Chief Financial Officer further stated that DoD agrees that contract financing payments are assets that have a probable economic benefit that can be obtained or controlled by the entity. He stated that contract financing payments do not fall within the standard definition of general ledger accounts. Therefore, they are classified under the account titled “Other Assets.”

**Audit Response.** The Deputy Chief Financial Officer comments are not responsive. The assets financed by the contract financing interim payments were Construction WIP, PP&E, or expenses. The assets that were funded by the contract financing payments meet the SFFAS requirements for Construction WIP and PP&E. Pages 3 and 4 of this report discuss the SFFAS requirements for PP&E and Construction WIP. There is a distinction between the financial statement presentation of the asset that DoD has gained future use of and the mechanism used to acquire the asset (the contract financing interim payment). The distinction is key in determining how to present the information on the DoD financial statements. The \$10.41 billion of the \$33.16 billion contract financing payments that we reviewed were payments for assets that will be major weapon system programs that are currently being built. To report these \$10.41 billion of assets anywhere except Construction WIP would distort the DoD Balance Sheet.

We disagree that all contract financing payments should be considered assets. Our audit results clearly show that this is not the case. Specifically, \$20.61 billion of the \$33.16 billion in contract financing interim payments that we reviewed were appropriately recorded as expenses. DoD needs additional policy that DFAS and the Military Departments can reference and use to determine

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whether contract financing interim payments represent an asset purchase or an expense.

Additionally, the Deputy Chief Financial Officer did not comment on revising the DoD Regulation 7000.14-R so that it addressed circumstances in which contract financing payments should be recorded as expenses. We request that the Deputy Chief Financial Officer reconsider his position and provide additional comments.

**3. Expand DoD Regulation 7000.14-R, “DoD Financial Management Regulation,” to include guidance on when Research, Development, Test, and Evaluation funds should be included in the capitalized cost of a functional end item and how to record the disbursements on the financial statements.**

**Management Comments.** The Deputy Chief Financial Officer partially concurred and stated that DoD Regulation 7000.15-R volume 4, chapter 6, subparagraph 06103.A.8.e. accurately reflects the DoD accounting practice and policy of capitalizing RDT&E items associated with the development of an end item that is produced for operational use. He agreed that DoD Regulation 7000.14-R volume 4, chapter 17, paragraph 170202 requires clarification. He agreed to revise subparagraph 170202.A. to state that expenses incurred for RDT&E should be recorded and reported as an expense unless they are associated with the development of an end item that is produced for operational use and should be capitalized.

**Audit Response.** The Deputy Chief Financial Officer comments are partially responsive. We agree with the wording of the revision to paragraph 170202.A. This revision will be consistent with the guidance in DoD Regulation 7000.14-R volume 4, chapter 6, subparagraph 060103.A.8. However, the comments did not include specific guidance that the Military Departments can use to determine whether the contract financing payment is associated with an end item for operational use. More detailed guidance would improve the likelihood that DFAS or the Military Departments make an accurate determination. Additionally, the Deputy Chief Financial Officer comments did not address the inconsistency between DoD Regulation 7000.14-R volume 4, chapter 6, paragraph 060106.G. and volume 4, chapter 6, paragraph 060202.B. Paragraph 060106.G. states that entities can accumulate engineering and design costs in the Construction WIP account. However, paragraph 060202.B. indicates that the Construction WIP account should be used for real property construction projects and does not specify other types of projects, such as PP&E acquisitions. A revision of paragraph 060202.B. that clarifies that the Construction WIP account could also include weapon system PP&E acquisition would remove the inconsistency in the two DoD Regulation 7000.14-R sections. We request that the Deputy Chief Financial Officer reconsider his position and provide additional comments.

**4. Monitor whether contract financing interim payments are being reported and presented in accordance with the new DoD Regulation 7000.14-R “DoD Financial Management Regulation” requirements.**

**Management Comments.** The Deputy Chief Financial Officer nonconcurred and stated that he did not agree that any changes to DoD Regulation 7000.14-R

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related to the reporting of contract financing interim payments were required. Therefore, no monitoring is needed.

**Audit Response.** The Deputy Chief Financial Officer comments are not responsive. Without changes to DoD Regulation 7000.14-R reporting policy for contract financing interim payments, users of the existing guidance will continue to make material departures from generally accepted accounting principles that result in misclassification of assets and expenses. The misclassification of contract financing interim payments is significant. Contract financing interim payments represented \$10.41 billion of assets purchased from FY 2004 through 2006 and were material to the Construction WIP account. Additionally, without changes to the disclosure in Note 1R, DoD will continue to misrepresent the total amount of contract financing payments and the presentation of contract financing interim payments. We request that the Deputy Financial Officer reconsider his position and provide additional comments.

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## Appendix A. Scope and Methodology

We conducted this performance audit from October 2006 through July 2007 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We obtained all recorded contract financing interim payments made by the DFAS Columbus MOCAS system from October 2003 through September 2006. After receiving this universe of contract financing interim payments, we judgmentally selected 29 contracts to review based on dollar values and other factors. We obtained access to the Electronic Document Access system at DFAS Columbus to review scanned contracts and electronically-generated entitlement information to determine the type of asset that each interim payment was financing. For contracts in which the contract information in Electronic Document Access was insufficient, we contacted the procurement contracting officer to inquire about the asset that was purchased.

We then reviewed the Federal Accounting Standards and DoD guidance to determine how the payments for the assets or services that DoD purchased should be recorded on the financial statements. Specifically, we determined, based on SFFAS No. 6 and SFFAS No. 23, that if the contract would result in the purchase of a functional end item, DoD should capitalize all costs in either the Military Equipment or Construction WIP balance. If the contract was for the purchase of a prototype or plan, DoD should expense all costs. However, if the contract was for the purchase of a prototype or plan and a contract for a final asset was initiated, DoD should capitalize all costs for the original contract from the date of the new contract. For contracts that were for services, DoD should have expense all costs.

We obtained accounting data for the Army from the Contract Load Reconciliation System (CLRS) and the Standard Operation and Maintenance Army Research and Development System (SOMARDS). We obtained accounting data for the Navy from the Standard Accounting and Reporting System (STARS) Headquarters Command Module (HCM), STARS Field Level (FL), and Sigma systems. We obtained accounting data for the Air Force from the General Accounting and Finance System-Rehost (GAFS-R) system. We then assessed the systems' compliance with the posting logic for each system and determined whether the data provided could be reconciled with the data reported by the Treasury.

Our scope was limited in that we did not perform completeness testing on the universe of transactions received from the MOCAS system. We did not review the MOCAS data to ensure that the appropriate "kind" of contract was used by DFAS. We did not perform testing to verify the amounts reported for Military Equipment because another Department of Defense Office of Inspector General audit team is in the process of reviewing the assertion package for Military Equipment Valuation. We reviewed only the overall posting logic for each of the

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Services. We did not review the actual posting for each of our individual sample disbursements.

**Use of Computer-Processed Data.** We relied on computer-processed data from the MOCAS system to identify contract financing interim payments disbursed from October 1, 2003, through September 30, 2006. During a prior audit, we determined that the transactions DFAS Columbus entered into MOCAS were generally accurate, based on the scanned invoices. Therefore, we did not perform a reliability assessment of the MOCAS data. We also determined that the data in MOCAS were not altered and existed in the system. Based on these assessments, the MOCAS data were reliable.

We also relied on computer-processed data from the CLRS, GAFS-R, SOMARDS, Sigma, STARS-FL, and STARS-HCM accounting systems. We did not verify the entire posting logic for each system. However, we did verify the accuracy of the application of the posting logic for each of our sample disbursements. Based on our assessments, the data from the accounting systems will not negatively affect the results of this audit.

**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

During the last 5 years, the Department of Defense Inspector General (DoD IG) has issued three reports discussing the presentation of contract financing payments. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

## DoD IG

Report No. D-2006-050, "Accuracy of Navy Contract Financing Amounts," February 13, 2006

Report No. D-2006-025, "Report on Accuracy of Air Force Contract Financing Amounts," November 14, 2005

Report No. D-2005-062, "Report on Recording and Accounting for DoD Contract Financing Payments," May 10, 2005

## Appendix B. Sample Contracts

We reviewed 29 contracts. The table shows the contracts reviewed, the item purchased, and the total dollar value of the contract financing interim payments.

<b>Sample Contracts with Contract Financing Interim Payments</b> (in millions)		
<u>Contract Number</u>	<u>Program/Item</u>	<u>Value of Contract Financing Interim Payments Reviewed</u>
DAAH2300CA001	RAH-66 Comanche	\$764.0
N0003003C0100	Trident II	552.5
N0003004C0100	Trident II	472.1
N0003005C0100	Trident II	413.8
N0001902C3002	F035 Joint Strike Fighter	8,947.4
DAAE0739F001	Unit of Action	3,210.9
W56HZV05C0724	Unit of Action	2,224.6
N0001903C0057	E-2D Advanced Hawkeye	1,335.9
N0002403C6111	FIM-161 SM-3	954.0
F3365799D00280023	B-2 Radar Modernization Program	258.9
F3365791C0006	F-22 Raptor	820.3
F0470102C0009	Space Based Infrared Systems Low	614.2
F3365702C2000	C-5 RERP	685.5
N0002403C6110	Aegis Ballistic Missile Defense	550.3
N0002498C5197	ACS Baseline Upgrades	605.0
F1962800C0100	MP-RTIP	597.8
F3365701C0047	C-130 AMP	584.3
N0002403C2311	Littoral Combat Ship	327.7
FA880804C0023	TSAT Advanced Wideband System	289.4
DAAE3098C1032	155MM Unitary Projectile	260.4
N0001902C3003	F135 Propulsion System and Engine	2,450.2
F0470102C0002	Advanced Extremely High Frequency	1,990.3
F2960197C0001	Airborne Laser	1,186.9
N0001993C0006	CV and MV-22 Osprey	688.5
N0003904C2009	Mobile User Objective System	671.3
N0001905C0030	Presidential Helicopter Replacement	598.8
F3460195C0270	Contractor Logistic Support	120.3
N0002405C5346	DD(X) Design	765.8
DAAA0902D00070027	Operational Support	<u>213.8</u>
<b>Total</b>		<b>\$33,154.9</b>

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## **Appendix C. Presenting Other Types of Contract Financing Payments on the Balance Sheet**

DoD OIG Report No. D-2005-062, “Report on Recording and Accounting for DoD Contract Financing Payments,” May 10, 2005, addressed the presentation of certain contract financing payments on the DoD financial statements. Report No. D-2005-062 concluded that DoD did not record progress payments, performance-based payments, and commercial item financing payments on the Consolidated Balance Sheet of the DoD Financial Statements in accordance with Federal Accounting Standards. The report stated that DoD inappropriately recorded contract financing payments in the Other Assets account when it should have recorded the payments in an in-process asset account, such as Construction WIP.

The OSD(C)/CFO disagreed with the DoD OIG position and stated that DoD accounting practices and the DoD Financial Management Regulation policies for recording and accounting for contract financing payments are compliant with Federal Accounting Standards and accurately reflect the legal and financial status of DoD. OSD(C)/CFO further stated that classifying contract financing payments under Other Assets, with full disclosure in the footnotes as to their nature, provides relevant and reliable information to decision makers and financial statement users and is fully compliant with Federal Accounting Standards.

In response to the audit finding, the Deputy General Counsel (Acquisition and Logistics) stated that the title to the property paid for by the progress payment is transferred to the Government at the time of the payment. He also stated that the audit erroneously appears to equate progress payments with partial acceptance of the contracted end item. He added that whether progress payment inventory is booked as Work-In-Process or as Other Assets is a matter of accounting policy.

We disagreed with the comments from the Deputy Chief Financial Officer. When we examined the types of assets purchased with contract financing payments, the associated documentation showed that the items more appropriately fit the category of Construction WIP (for PP&E being manufactured) or Inventory WIP (for inventory being acquired). We maintain our position that when DoD makes contract financing payments, DoD should present the PP&E and inventory-related items as such in the financial statements.

Despite the audit finding, the OSD(C)/CFO continues to report those types of contract financing payments in the Other Assets account.



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## **Appendix D. Report Distribution**

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

Under Secretary of Defense for Acquisition, Technology, and Logistics  
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)

### **Department of the Navy**

Naval Inspector General

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

Assistant Secretary of the Air Force (Financial Management and Comptroller)

### **Combatant Command**

Inspector General, U.S. Joint Forces Command

### **Other Defense Organizations**

Director, Defense Finance and Accounting Service

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

Office of Management and Budget

### **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Homeland Security and Governmental Affairs

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

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

# Under Secretary of Defense Comments



COMPTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100

OCT 1 2007

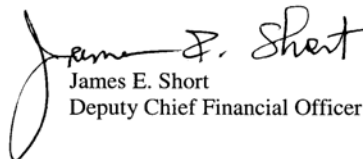
MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE FINANCIAL AUDITING  
SERVICE, OFFICE OF INSPECTOR GENERAL,  
DEPARTMENT OF DEFENSE

SUBJECT: Comments to Draft Audit Report, "Reporting of Contract Financing Interim  
Payments on the DoD Financial Statements,"  
(Project No. D2007-D000FJ-0058.000)

This memorandum is in response to your request for comments on the audit  
recommendations contained in the subject draft audit report, issued August 28, 2007.

Upon review of the draft report, we do not concur with the Office of Inspector  
General, Department of Defense recommendations that the Department revise the  
Department of Defense Financial Management Regulation ("DoDFMR") to require the  
military departments to record contract financing interim payments as Construction  
Work-in-Process. As we have previously responded with respect to this issue, and as  
reflected in Appendix C of the draft report, we maintain that the Department's accounting  
practices and the "DoDFMR" policies for contract financing payments are compliant  
with the Statements of Federal Financial Accounting Standards, and accurately reflect the  
legal and financial status of the Department. Our detailed response to the report  
recommendations is outlined in the Attachment.

We appreciate the opportunity to respond to your request for comments on the  
audit recommendations. My point of contact is Ms. Victoria Post. She can be reached by  
telephone at 703-693-6520 or email at victoria.post@osd.mil.

  
James E. Short  
Deputy Chief Financial Officer

Attachments:  
As stated

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**DOD OIG DRAFT REPORT DATED AUGUST 28, 2007**  
**PROJECT NO. D2007-D000FJ-0058.000**  
**“REPORTING OF CONTRACT FINANCING INTERIM PAYMENTS**  
**ON THE DOD FINANCIAL STATEMENTS”**

**OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)**  
**(OUSD)(C) COMMENTS TO THE DOD OIG RECOMMENDATIONS**

**RECOMMENDATION 1:** Recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer (USD(C)/CFO) rescind the interim guidance checklist that directs its reporting entities to report contract financing interim payments in the “Outstanding Contract Financing” balance.

**USD(C) RESPONSE:** Nonconcur. The quarterly financial statement note disclosure checklist (referred to as the “interim guidance checklist” in the draft report) accurately reflects the “DoDFMR” guidance related to reporting of contract financing interim payments in the Department’s consolidated balance sheet under the category of “Other Assets,” in a sub caption entitled “Outstanding Contract Financing Payments.”

**RECOMMENDATION 2:** Recommend that the USD(C)/CFO revise the Financial Management Regulation to include guidance to record contract financing interim payments as Construction Work-in-Process or expense.

**USD(C) RESPONSE:** Nonconcur. The Department does not concur that contract financing interim payments should be recorded as Construction Work-in-Process because these payments do not meet the Statements of Federal Financial Accounting Standards (SFFAS) definition of Property, Plant and Equipment (PP&E).

SFFAS No. 6, “Property, Plant and Equipment (PP&E),” defines PP&E as tangible assets that have an estimated useful life of 2 years or more; are not intended for sale in the ordinary course of operations; and are intended to be used or available for use by the entity. Contract financing payments are cash disbursements made to a contractor to finance the performance under the contract prior to acceptance of goods or services. Identifying these cash disbursements as PP&E, prior to acceptance of goods, would imply that we have acquired tangible assets that are intended to be used or available for use by the Department. Reporting cash disbursements as PP&E in the Department’s balance sheet would mislead financial statement users as to the property owned, managed, or controlled by the Department and reduce the usefulness and clarity of the financial statement information currently reported.

Attachment  
Page 1 of 2

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However, we agree that contract financing payments are assets, which have probable economic benefit that can be obtained or controlled by the entity. Cash disbursements in the form of contract financing payments do not fall within the standard definitions in the general ledger accounts, established by the Department of the Treasury. Therefore, these assets are classified under the account entitled "Other Assets," defined as "other assets not otherwise classified." In our opinion, classifying contract financing payments under "Other Assets," with full disclosure in Note 6, provides relevant and reliable information to decision makers and financial statement users and is fully compliant with the SFFAS.

**RECOMMENDATION 3:** Recommend that the USD(C)/CFO expand the Financial Management Regulation to include guidance on when Research, Development, Test and Evaluation (RDT&E) funds should be included in the capitalized cost of a functional end item and how to record the disbursements on the financial statements.

**USD(C) RESPONSE:** Partially concur. The Department's RDT&E business rules were incorporated in the "DoDFMR" Volume 4, Chapter 6, in July 2006. As such, Volume 4, Chapter 6, subparagraph 06103.A.8.e. accurately reflects the Department's accounting practice and policy of capitalizing RDT&E items associated with the development of an end item that is produced for operational use. However, we agree Volume 4, Chapter 17, paragraph 170202 requires clarification. We will revise Volume 4, Chapter 17, subparagraph 170202.A. to state that expenses incurred for RDT&E should be recorded and reported as an expense item unless they are associated with the development of an end item that is produced for operational use and should be capitalized. The estimated completion date is December 31, 2007.

**RECOMMENDATION 4:** Recommend that the USD(C)/CFO monitor whether contract financing interim payments are being reported and presented in accordance with the new Financial Management Regulation requirement.

**USD(C) RESPONSE:** Nonconcur. As discussed above, we do not agree any changes are required in the "DoDFMR" policies related to reporting of contract financing interim payments, thus no need to monitor compliance with changed policies.

Attachment  
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## **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