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### **Acronyms**

ADA	Antideficiency Act
BVN	Bureau Voucher Number
DFAS	Defense Finance and Accounting Service
FAR	Federal Acquisition Regulation
FASAB	Federal Accounting Standards Advisory Board
FMR	Financial Management Regulation
GAO	Government Accountability Office
OSD	Office of the Under Secretary of Defense
PCIE	President's Council on Integrity and Efficiency
SAF (FM)	Assistant Secretary of the Air Force (Financial Management and Comptroller)
SFFAS	Statement of Federal Financial Accounting Standards
T&M/LH	Time-and-Materials and Labor-Hour



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

March 12, 2008

MEMORANDUM FOR ASSISTANT SECRETARY OF THE AIR FORCE  
(FINANCIAL MANAGEMENT AND COMPTROLLER)  
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING  
SERVICE

SUBJECT: Report on Vendor Pay Disbursement Cycle, Air Force General Fund  
(Report No. D-2008-063)

We are providing this report for review and comment. We considered comments from the Air Force and Defense Finance and Accounting Service when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Air Force and Defense Finance and Accounting Service comments were partially responsive. We request additional Air Force comments on Recommendation A.1.a.(1), and additional Defense Finance and Accounting Service comments on Recommendations A.3, B.1, B.2.a, and B.2.b. As a result of management comments, we deleted Recommendation A.1.a.(2). We request all comments by May 12, 2008.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to AudDFS@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 Ms. Amy J. Frontz at (303) 676-7392 (DSN 94-926-7392) or Mr. John W. Barklage at (303) 676-3298 (DSN 94-926-3298). See Appendix D for the report distribution. The team members are listed inside the 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-2008-063

March 12, 2008

(Project No. D2004-D000FD-0040.004)

### Vendor Pay Disbursement Cycle, Air Force General Fund

#### Executive Summary

**Who Should Read This Report and Why?** Air Force contracting officers, fund holders, resource managers, and Air Force and Defense Finance and Accounting Service (DFAS) certifying officers and finance and accounting managers should read this report. This report discusses the need for improving internal control over the Air Force vendor pay disbursement cycle and summarizes the areas of risk previously reported in this series.

**Background.** Management is responsible for establishing and maintaining an internal control environment and structure to assure effective and efficient operations, reliable financial reporting, and compliance with laws and regulations. The Inspector General Act of 1978, as amended, provides for the independent review of agency programs and operations in accordance with generally accepted government auditing standards which require audit to report on internal control and compliance with laws and regulations. Such a review of the vendor pay disbursement cycle spans the acquisition; funding; delivery, receipt, and acceptance; payment; and recording of the financial transactions in the official accounting records. This is the final report in a series of five reports on internal control of the Air Force General Fund vendor pay disbursement cycle.

**Results.** The Air Force and DFAS did not establish and maintain adequate and effective internal control over the Air Force vendor pay disbursement cycle. We reported numerous internal control weaknesses in contract formation and funding, funds control, vendor payment, and financial accounting. The reported weaknesses represent a high risk that violations of laws and regulations not only occurred, but will likely continue to occur if corrective action is not taken. As a result, the Air Force and DFAS will continue to be at risk in the areas reported, and the unreliability of controls will affect the efficiency of audit services. Specifically, management is not taking full advantage of the benefits of internal control audits that Inspectors General and Chief Financial Officers recognize as: (1) improving internal control and reducing material weaknesses; (2) reducing errors and improving data integrity, documentation reliability, and reporting; and (3) improving agency focus and oversight. A thorough review should be undertaken of the internal control weaknesses reported and action taken to establish the policies, procedures, system changes, and training necessary to mitigate the internal control risk identified. See finding A for the detailed recommendations.

DFAS erroneously processed time-and-materials and labor-hour contract interim payments containing materials as if they were subject to the Prompt Payment Act. DFAS paid the interest without appropriate authority. As a result, DFAS paid interest in violation of law and regulation, thus exposing itself to potential Antideficiency Act violations. A definitive legal opinion should be requested on this matter and appropriate actions taken in response to that opinion. See finding B for detailed recommendations.

Delayed subcontractor's billing resulted in the use of appropriations that were no longer available to pay for work on a time-and-materials and labor-hour contract. Air Force personnel indicated that the contractor incurred the costs in an earlier period, but could not bill the Government until the subcontractor submitted its invoices and the contractor paid the subcontractor in FY 2004. We believe that the Government did not incur a liability until the prime contractor actually received the bill from the subcontractor. However, because available guidance is unclear, we believe that a legal opinion is necessary to determine whether the Government should be recording the third-party liability for subcontractors work on time-and-materials and labor-hour contracts. See finding C for the detailed recommendations.

**Management Comments and Audit Response.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of seven recommendations, agreeing to reiterate the internal control policies in the Manager's Internal Control Program Procedures (AFI65-201) to functional areas. He also agreed to coordinate with the other agencies to address payments for cost reimbursement for services or contract financing. However, the Deputy Assistant Secretary nonconcurred with one recommendation and did not provide sufficient additional documentation on one of the five preliminary Antideficiency Act investigations we requested to support the General Counsel's legal determinations. In response to the draft report, the Deputy Assistant Secretary also agreed to take any required action in response to a DoD General Counsel legal opinion received regarding liability recognition.

The Director, Corporate Reporting Standards & Compliance, DFAS concurred with one recommendation, partially concurred with one recommendation, and nonconcurred with two recommendations. The Director requested and received a legal opinion from the DFAS Deputy Assistant General Counsel, Accounting and Commercial Law, instead of the DoD General Counsel, on the legal authority for DFAS to make interest entitlement decisions based on the predominant contract line item, and to revise procedural guidance based on that decision. We do not agree with that legal opinion. Because this is an interpretation of DoD policy, we recommend DFAS General Counsel request an opinion from the DoD, Office of General Counsel. The Director also did not agree to revise accounting policies for foreign currency gains and losses, stating that DoD OIG's interpretation of a generally accepted accounting principle is problematic in that it pertains to the translation of foreign subsidiary financial statements to U.S. dollar equivalents, and DoD does not prepare financial statements in host country currencies. We do not agree that it does not apply to the activities in this report, because the principle relates to "transactions denominated in a currency other than the entity's functional currency." DoD deals with such transactions as evidenced by the need for a foreign currency fluctuation account. The Director further did not agree to segregate the material and labor portions of time-and-materials and labor-hour contract interim payments to prevent interest being paid on late payments for materials. He stated that DFAS has no authority to perform payment-by-payment analysis and pay or not pay interest based on the characteristics of the specific item, and that DFAS determines whether a contract is for services at the contract level. We do not agree that DFAS has no authority to perform a payment-by-payment analysis on contract payments. The February 2007 change to FAR 52.232-7 requires DFAS to review payments on time-and-material and labor-hour contracts so that interest will not be paid on late payments for materials.

We request that the Assistant Secretary of the Air Force (Financial Management and Comptroller) and Director, Defense Finance and Accounting Service reconsider their positions. We request all comments to the final report by May 12, 2008. See the Finding sections for a discussion of management comments to the findings and recommendations, and the Management Comments section for the complete text of the comments.

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## Background

Management is responsible for establishing and maintaining an internal control environment and structure to assure effective and efficient operations, reliable financial reporting, and compliance with laws and regulations. The Inspector General Act of 1978, as amended, provides for the independent review of agency programs and operations in accordance with generally accepted government auditing standards which require auditors to report on internal control and compliance with laws and regulations. Such a review of the vendor pay disbursement cycle spans the acquisition; funding; delivery, receipt, and acceptance; payment; and recording of the financial transactions in the official accounting records.

Three types of internal controls exist: compliance, operations, and financial reporting. In this series of audits, we conducted a series of control sample tests related to the three types of internal controls as presented in the Government Accountability Office (GAO) and President's Council on Integrity and Efficiency (PCIE) Financial Audit Manual. In accordance with these guidelines,<sup>1</sup> we randomly selected 45 contracting actions for a comprehensive examination of:

- the nature and funding of the contracts;
- delivery, receipt, and acceptance;
- payment; and
- financial recording of the related budgetary and proprietary transactions in the official accounting records.

In a sample of 45 items, one defect indicates the risk is high that the relevant internal control is not effective.<sup>2</sup> Depending on the type and nature of the internal control deviation, the internal control defect might be significant as a separate finding or treated as one of a homogeneous group of like errors and related causes.

The following is a summary of the findings and recommendations made in the four reports on the Vendor Pay Disbursement Cycle of the Air Force General Fund in this series.

**Contract Formation and Funding.**<sup>3</sup> Internal control was not effective to ensure vendors were properly paid with Air Force General Fund appropriations in accordance with laws and regulations. We reported that Defense Finance and Accounting Service (DFAS) personnel improperly paid 13 of the 45 contracting actions from appropriations that were either not permitted by law, or the goods or

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<sup>1</sup> GAO/PCIE Financial Audit Manual, section 450, "Sample Control Tests," July 2001.

<sup>2</sup> GAO/PCIE Financial Audit Manual, section 450, figure 450.1, table 1, "Sample Sizes and Acceptable Numbers of Deviations," July 2001.

<sup>3</sup> Report on Vendor Pay Disbursement Cycle, Air Force General Fund: Contract Formation and Funding (D-2006-056), March 6, 2006.

services were not a bona fide need of the period the funds were available for obligation (finding A). We also reported that 2 of the 45 vendors performed services before the contracts were properly funded (finding B).

**Funds Control.**<sup>4</sup> Internal control was not effective to ensure that Air Force personnel effectively monitored and took corrective action when DFAS personnel used incorrect funds to pay for goods and services. In 7 of the 45 contracting actions, personnel did not always use the correct line of accounting (finding A). We also reported that internal control was not effective when Air Force personnel did not monitor and follow up on unliquidated obligations for 11 of the 45 contracting actions (finding B).

**Payments to Vendors.**<sup>5</sup> Internal control was not effective to ensure that vendors were paid from the correct appropriations in 3 of the 45 contracting actions (finding A), vendors were paid in accordance with the contract terms and conditions in 25 of the 45 contracting actions (finding B), and cash management practices were in compliance with laws and regulations in 18 of the 45 contracting actions (finding C).

**Financial Accounting.**<sup>6</sup> Internal control was not effective to ensure that transactions were recognized on the date the financial events transpired, contract holdbacks and unfunded liabilities were properly posted, internal edits existed to ensure that all liabilities were posted to the accounting records in compliance with laws and regulations, and transactions could be traced to the source documents to support the accounting entries in the United States Standard General Ledger.

## Objectives

Our overall audit objective was to assess internal controls and compliance with laws and regulations pertaining to the vendor pay disbursement cycle in the Air Force General Fund and supported activities. See Appendix A for a discussion on the scope and methodology, Appendix B for critical guidance used in this audit, and Appendix C for a complete list of the 45 contracting actions randomly selected for examination.

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<sup>4</sup> Vendor Pay Disbursement Cycle, Air Force General Fund: Funds Control (D-2006-085), May 15, 2006.

<sup>5</sup> Vendor Pay Disbursement Cycle, Air Force General Fund: Payments to Vendors (D-2007-027), November 24, 2006.

<sup>6</sup> Vendor Pay Disbursement Cycle, Air Force General Fund: Financial Accounting (D-2007-059), February 9, 2007.

## A. Controls Over Air Force Vendor Pay Disbursement Cycle

The Air Force and Defense Finance and Accounting Service did not establish and maintain adequate and effective internal control over the Air Force vendor pay disbursement cycle. Representatives of the Assistant Secretary of the Air Force (Financial Management and Comptroller) (SAF/FM) and the Defense Finance and Accounting Service, in their responses to this series of reports, did not take appropriate actions to address the weaknesses. We reported numerous internal control weaknesses in contract formation and funding, funds control, vendor payments, and financial accounting, but management's comments:

- nonconcurred with our recommendations without providing adequate support for doing so,
- included inconsistent information, and
- attempted to lessen the materiality of the audit results by questioning the size of the audit sample.

In our evaluations of management's comments, we generally concluded management did not thoroughly examine the criteria and the facts referenced in the reports. While DFAS management disagrees with our assessment of control risk, we reached our conclusion by using sample control test methodology, as established in the GAO/PCIE Financial Audit Manual.<sup>7</sup> The results of such an assessment are used to evaluate management's compliance with laws and regulations, and to determine the nature, timing, and extent that substantive testing needed to determine whether a material weakness or misstatement in the financial statements has occurred. Therefore, the internal control weaknesses we reported represent a high risk that violation of laws and regulations not only occurred, but will likely continue to occur if corrective action is not taken. In addition, the unreliability of internal controls will affect the efficiency of audit services. Specifically, management is not taking full advantage of the benefits of internal control audits that Inspectors General and Chief Financial Officers recognize as: (1) improving internal control and reducing material weaknesses; (2) reducing errors and improving data integrity, documentation reliability, and reporting; and (3) improving agency focus and oversight.

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<sup>7</sup> GAO/PCIE Financial Audit Manual, section 450, "Sample Control Tests," July 2001.

## Criteria for Internal Control

The Inspector General, DoD, performs audits in accordance with the GAO/PCIE Financial Audit Manual. In the internal control phase, the auditor evaluates controls for each significant cycle and accounting application to determine whether significant financial management systems substantially comply with Federal financial management systems requirements, Federal accounting standards, and the United States Standard General Ledger at the transaction level. A cycle or an accounting application is considered significant if it processes transactions in excess of design materiality, or if it supports a significant account balance in the financial statements. Auditors may also identify other cycles, accounting applications, or financial management systems as significant based on qualitative considerations. For example, financial management systems covered by the Federal Financial Management Improvement Act include not only systems involved in processing financial transactions and preparing financial statements, but also systems supporting financial planning, management reporting, budgeting activities, systems accumulating and reporting cost information, and the financial portion of mixed systems such as acquisition systems.

The 2003 revision of the GAO Government Auditing Standards explains an examination of internal controls may include:

- effectiveness and efficiency of operations, including the use of resources,
- reliability of financial reporting,
- compliance with applicable laws and regulations and provisions of contracts, and
- safeguarding of assets.

In addition, the GAO Government Auditing Standards requires auditors to report the views of responsible officials. Those views are expressed by management's comments about internal control deficiencies, illegal acts, and violation of provisions of contracts, and through the corrective actions these officials plan to take.

According to the GAO "Standards for Internal Control in the Federal Government," November 1999, a positive control environment that sets a positive and supportive attitude toward internal control is the first internal control standard. In the GAO "Internal Control Management and Evaluation Tool," August 2001, one consideration of management's philosophy and operating style is that management places a high degree of importance on the work of the Inspector General and other evaluations and is responsive to information developed through their products. Another standard of internal control is that monitoring should ensure that the findings of audits and other reviews are promptly resolved. The evaluation tool considers whether managers promptly review and evaluate findings from audits, determine the proper actions to take, and take corrective actions within established time frames. If there are disagreements with the findings or recommendations, management is expected to demonstrate that those findings or recommendations are either invalid or do not warrant action.

## Management Responses

These four reports included 43 recommendations to three organizations within DoD: Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller), Office of the Assistant Secretary of the Air Force (Acquisition), and the Defense Finance and Accounting Service. Many of these recommended that SAF/FM coordinate with the other organizations to provide effective actions to correct the control weaknesses identified in the report. Representatives of the SAF/FM and DFAS, in their response to this series of reports, did not take appropriate actions to address the internal control weaknesses. We reported numerous internal control weaknesses in contract formation and funding, funds control, vendor payment, and financial accounting. However, management comments:

- nonconcurred with recommendations without providing adequate support for doing so,
- included inconsistent information, and
- attempted to lessen the materiality of the audit results by questioning the validity of the sample size.

**Unsupported Comments.** While comments from the Assistant Secretary of the Air Force (Acquisition) concurred or concurred with the intent of all applicable recommendations, the comments from SAF/FM and DFAS, or their representatives tasked to answer the report, did not concur with most of the recommendations.

- In the first report in this series,<sup>8</sup> SAF/FM did not comment on seven of nine recommendations. The comments on the remaining two recommendations did not address the internal control weaknesses identified in the report.
- The representative from SAF/FM also did not comment on recommendations made in the third<sup>9</sup> and fourth reports<sup>10</sup> preferring to let DFAS management provide comments instead.

For the first report, SAF/FM did not address the internal control weaknesses in the 13 contracting actions that were identified in the report. While we reported Air Force personnel took action to correct one of the sampled items, the responses focused only on the two recommendations to perform Antideficiency Act (ADA) investigations on the contracting actions that we reported violated appropriation laws and regulations. In response to the draft report, management agreed to

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<sup>8</sup> Report on Vendor Pay Disbursement Cycle, Air Force General Fund: Contract Formation and Funding (D-2006-056), March 6, 2006.

<sup>9</sup> Vendor Pay Disbursement Cycle, Air Force General Fund: Payments to Vendors (D-2007-027), November 24, 2006.

<sup>10</sup> Vendor Pay Disbursement Cycle, Air Force General Fund: Financial Accounting (D-2007-059), February 9, 2007.

initiate preliminary investigations on four of the contracting actions. After we requested management to reconsider their position in the final report, they agreed to initiate preliminary reviews on three of the remaining contracting actions. We continue to believe the remaining contracting actions violated appropriation laws or regulations. However, even if the results of the preliminary reviews indicate that an ADA violation did not occur, the circumstances surrounding each deficiency still merit an examination of the contracting actions, policies, procedures, and training requirements to reduce the risk of actual violations in the future.

**Support for Disagreements.** Representatives of the Assistant Secretary of the Air Force (Financial Management and Comptroller) did not agree with our recommendations to perform investigations for possible ADA violations on five of the contracting actions in the first report, and the Central Site Director, DFAS Denver nonconcurred with the recommendations made in the fourth report without providing adequate support for doing so. After we provided details to SAF/FM outlining the inadequate support, we received sufficient additional documentation with management comments to the draft report on four of the contracting violations.<sup>11</sup> We discuss the fourth contracting action below, and the fifth action is discussed in finding C of this report.

**SAF/FM.** The Deputy Assistant Secretary, Financial Operations (Financial Management) did not require a preliminary review on one contracting action related to the DoD policy on the bona fide needs rule.<sup>12</sup> We believe the contractual circumstances surrounding the deficiency merits review. Our review of the supporting documents provided by management raised a number of questions as to their applicability to the sampled transactions. Management did not provide sufficient evidence that personnel followed DoD policy and contracting regulations.

**DFAS.** The Central Site Director, DFAS Denver nonconcurred with five of the six recommendations from the fourth report. While we have reconsidered our position on Recommendation 5, we continue to believe that the director did not have a reasonable basis for nonconcurring with Recommendations 1-4. We provided the criteria applied in the audit in Appendix B of the draft report. It cited the applicable guidance from the Office of Management and Budget, Federal Financial Management Improvement Act, Federal Accounting Standards Advisory Board (FASAB), and generally accepted accounting principles. However, the director did not rebut the recommended actions in response to the stated criteria.

**Recommendation 1** - The director's initial and final comments to this recommendation were not consistent with Federal Financial Management Improvement Act, Office of Management and Budget, and FASAB criteria. After reconsideration, the director restated on April 9, 2007, that the vendor and contract payment systems were subsidiary ledgers and the data was accessible in those systems. However, the director provided no

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<sup>11</sup> Sample numbers 11, 24, and 57.

<sup>12</sup> Sample number 27.

evidence the current Air Force general ledger was auditable in compliance with the applicable criteria.<sup>13</sup>

Specifically, we stated in the report that we could not readily trace transactions by source document reference and the effective date of the financial events through the Air Force base-level, vendor payment, and contract payment systems to the Air Force general ledger for disclosure in the financial statements. The director's statement that the vendor and contract payment systems were subsidiary ledgers to the general ledger is not consistent with the accounting definition for subsidiary ledgers and the general ledger as a control account. The entries made to the Air Force general ledger were not consistent with a daily journal entry that summarized the daily events and amounts in the control account. The internal control weakness that we addressed is that the data in the Air Force general ledger, used to prepare financial statements, do not represent, and are not directly traceable to, the financial events. The system that DFAS uses to trace transactions from reports to supporting documentation does not provide an adequate audit trail. The DoD Financial Management Regulation (FMR)<sup>14</sup> provides the key accounting requirements for DoD financial management systems. Key Accounting Requirement No. 8 states that in any compliant system, the financial transactions for which the system accounts must be traceable to individual source records. In addition, the FMR requires DFAS to maintain a complete and documented audit trail to support the reports it prepares.<sup>15</sup> Management did not address that weakness in relation to the rights and obligations and the completeness of management assertions.

Recommendation 2 - The director's initial and final comments on this recommendation were not consistent with the DFAS mission statement and recognized authority. We reported that DFAS calculates and recognizes foreign currency gains and losses on the date of disbursement. We recommended that DFAS process foreign currency gains and losses on the date of the payable in accordance with Generally Accepted Accounting Principles. The director responded that foreign currency gains and losses were processed in accordance with the DoD Financial Management Regulation, and DFAS did not have authority to deviate from the DoD policy.

According to the DFAS mission statement, DFAS supports the Office of the Under Secretary of Defense (OUSD) (Comptroller), the principal advisor to the Secretary of Defense for budgetary and fiscal matters. DoD Directive 5118.5, "Defense Finance and Accounting Service," December 13, 1991, states that "The Director, Defense Finance and Accounting Service (DFAS), is the principal DoD executive for accounting and finance requirements, systems, and functions." Therefore,

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<sup>13</sup> The director's comments discussed the future Defense Enterprise and Accounting Management System projected for full implementation in 2010.

<sup>14</sup> DoD FMR, volume 1, chapter 3, "Accounting Systems Conformance, Evaluation, and Reporting."

<sup>15</sup> DoD FMR, volume 6A, chapter 2, "Financial Reports Roles and Responsibilities," section 020201, subsection C., paragraph 7 and section 020203, subsection B.

DFAS is responsible for establishing and enforcing requirements, principles, standards, systems, procedures and practices to comply with finance and accounting statutory and regulatory requirements applicable to the DoD. Because the GAO did not waive that portion of Generally Accepted Accounting Principles in accounting for foreign currency gains and losses that is applicable to DoD, and because Generally Accepted Accounting Principles takes precedence over the DoD FMR, we believe it is appropriate that the Director, DFAS, as the principal DoD executive for accounting requirements, take the lead to establish and implement the policy through coordination with OUSD (Comptroller).

Recommendation 3 - The director's initial and final comments on this recommendation were not consistent with Office of Management and Budget criteria. As he did in Recommendation 1, the director nonconcurred by relying on the vendor and contract payment systems to maintain controls for recording the budgetary and proprietary transactions. As previously stated, we reported the weakness in context with the preparation of the financial statements, not whether the data was captured and stored in a feeder or mixed system.

The director's comments also were in conflict with Statement of Federal Financial Accounting Standards (SFFAS) No. 21, which amended SFFAS No. 7, paragraph 76. In SFFAS No. 7, FASAB did not allow agencies to restate prior period financial statements because of the unnecessary burden restatement presented to agencies at that time. This policy prevented agencies from presenting accurate comparative financial statements when the prior period statements contained a material error. In SFFAS No. 21, FASAB amended SFFAS No. 7 to require restatement of prior period financial statements for material errors discovered in the current period, if the statements are for comparative purposes, and if the effect of the error would be material to the financial statements in either period. While DFAS does prepare comparative statements for its clients, the director stated, "reinstatement [restatement] of prior period financial statements may end up disguising the impact of that delayed recognition of the financial event since Financial Managers are more likely to be reviewing the most current financial statements and not prior reinstated [restated] financial statements." We believe DFAS must have the capability to assess potentially material prior period adjustments created on a transaction or accrual basis and restate prior period financial statements in accordance with SFFAS No. 21.

Recommendation 4 - The director's initial and final comments on this recommendation were not consistent with the FASAB, SFFAS No. 1, and United States Standard General Ledger posting requirements. The director's final comments did not rescind his prior statement that contract holdbacks are recognized as accounts payable, instead of as other liabilities. In addition, the director did not change his position regarding the recognition of unfunded liabilities. The director maintained that "unfunded liabilities, as described in the audit report, is when Congress has authorized the Government to enter into contracts in advance of



appropriations. Contracts are not input into MOCAS<sup>16</sup> without appropriations.” We reported unfunded liabilities resulting from instances of vendor performance prior to the execution date of the delivery orders which provided funding.<sup>17</sup> However, unfunded liabilities can also arise after a funded contract is input and is later subject to the incremental funding clause under Federal Acquisition Regulation (FAR) 52.232-22. Under FAR 52.232-22, paragraph (i), a vendor can continue to perform and incur costs, which creates an unfunded liability. When additional funds are obligated on contract, the costs incurred are paid as if they were incurred when the funds were already obligated on the contract.

**Air Force Accounting and Finance Office.** The Director, Air Force Accounting and Finance Office provided comments to the third report on behalf of SAF/FM. The director nonconcurred with the three recommendations, stating:

In accordance with DoD 7600.7-M, June 1990, Department of Defense Internal Audit Manual, draft reports are required to be staffed through the management officials responsible for taking corrective action. In order to allow timely, responsible, and appropriate responses, DoDIG should revise the draft report to direct recommendations to the appropriate official. Due to the manner in which this draft report to direct recommendations is written, each agency in the overall recommendation had to determine their responsibility for the specific recommendations and answer independently. Air Force provides management comments for those specific recommendations applicable to SAF/FM and SAF/AQ [Acquisition].

We do not agree with the director that DoD 7600.7-M restricts the format of the recommendations as interpreted. While it is true the audit manual states that draft reports are to be staffed with management officials who are responsible for taking corrective actions, we believe that in context to the nature and scope of this audit series that recommendations should encourage a cooperative and integrated effort. The Office of Management and Budget, Circular A-123, “Management’s Responsibility for Internal Control,” December 21, 2004, observes:

Instead of considering internal control as an isolated management tool, agencies should integrate their efforts to meet the requirements of the FMFIA with other efforts to improve effectiveness and accountability. Thus, internal control should be an integral part of the entire cycle of planning, budgeting, management, accounting, and auditing. It should support the effectiveness and the integrity of every step of the process and provide continual feedback to management.

**Inconsistent Information.** Representatives from OUSD (Acquisition, Technology, and Logistics), Office of the Assistant Secretary of the Air Force (Acquisition), SAF/FM, and DFAS provided inconsistent information in comments on recommendations in the third report. OUSD (Acquisition, Technology, and Logistics) and Office of the Assistant Secretary of the Air Force

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<sup>16</sup> Mechanization of Contract Administration Services.

<sup>17</sup> Sample numbers 4 and 26.

(Acquisition) concurred with recommendations that required contracting officers to ensure the proper clauses were inserted in cost-reimbursement contracts. However, the Center Site Director, DFAS Denver disagreed, stating the DFAS Contract Pay Operations personnel had a means to determine whether the interim payments were for cost-reimbursement for services or contract financing. DFAS audit support stated that DFAS personnel review the description of the deliverables in the contract, and if the contract line item describes mostly services, DFAS pays the vendor interest if it is owed. Therefore, DFAS personnel do not examine the contract to determine whether the contracting officer inserted the requisite clause.

**Validity of Sample Size.** The Central Site Director, DFAS Denver did not agree that the internal control weaknesses identified in the third report and fourth reports presented a high risk. The director stated that he did not view a sample of 45 contracting actions as representative of the total contracts and transactions processed. The director continued by stating, “The sampling size is flawed and risk, in fact, is low and internal controls are effective.” However, the director did not provide an independent evaluation or risk assessment that proved the risk is low. The sample size and test methodology we used is representative of the universe and recommended for use by the GAO/PCIE Financial Audit Manual. The sample methodology is the generally accepted method for economically and effectively determining the nature, timing, and extent of planning the substantive testing necessary to determine the materiality of the internal control weaknesses and impacts. We believe management should use such control sample test methods to initially assess the reliability of its internal control under Office of Management and Budget Circular A-123.

## Audit Risk

The internal control weaknesses discussed in this series of reports represent a high risk that violation of laws and regulations not only occurred but will likely continue to occur if corrective action is not taken. In addition, the unreliability of internal controls will affect the efficiency of audit services. Specifically, management is not taking full advantage of the benefits of internal control audits that Inspectors General and Chief Financial Officers recognize as: (1) improving internal control and reducing material weaknesses; (2) reducing errors and improving data integrity, documentation, reliability, and reporting; and (3) improving agency focus and oversight.

Each report in this series overlaps, presenting internal control weaknesses within four respective functional areas. Those functional areas represent a segregation of duties among the contracting officers; Air Force personnel who receive the goods or services, resource managers, and funds holders; DFAS vendor and contract pay disbursing and certifying officers; and the DFAS accountants. The series results were meant to be viewed as a whole, although each subject matter area was addressed separately.

The Director, Air Force Accounting Policy and Compliance (Financial Management) stated in his comments on the fourth report that “we have an overriding concern that there is no mention of compensating controls in this draft report.” We did examine the compensatory controls, although not as they necessarily existed within each subject matter area, but in the overall segregation of duties and dispensation of authority, documentation and audit trail, procedural guidelines, and information processing related to the acquisition and vendor pay

disbursement cycle. We reported that a high risk existed in many of the reported internal control weaknesses.

While some management may view risk as low and internal control effective, the Inspector General, as principal auditor, must perform an independent assessment of risk and base the cost of future audit services on that assessment. The higher the risk that internal control is not effective, the more substantive testing must be done at an increased cost to the Air Force. In our opinion, management's philosophy and commitment to the internal control structure, as reflected in the comments and views expressed in response to this series of reports, needs to be reassessed, in order to strengthen the internal control environment.

## **Management Comments on the Finding and Audit Response**

**Management Comments.** The Director, Corporate Reporting, Standards and Compliance, DFAS did not fully concur with portions of the finding relating to four recommendations from the fourth report in this series, and provided additional comments. For recommendation number 1, the Director partially concurred stating that a need does not exist for system changes and integration of the Mechanization of Contract Administration Services system, Integrated Accounts Payable System, General Accounting and Finance System–Base Level, and General Accounting and Finance System–Rehost in order to recognize transactions as of the date the financial events transpired. The Director based this conclusion on a new accrual process first used during the September 2007 end-of-month reporting. He stated that this is a new process for estimating and recording the MOCAS Accounts Payable accruals at the end of each reporting period, and that these accruals account for the “financial events” that must be recorded at the end of the month. For recommendation number 2, the Director nonconcurred stating that the gain or loss on foreign currency transactions arguably fails both the “measurable with sufficient reliability” requirement and “cost-benefit constraint” required for recognition of the liability of a delivered item, as established in Statement of Financial Accounting Concept Number 5. For recommendation number 3, the Director concurred with the need to adjust financial statements for material prior period adjustments. However, the Director nonconcurred with the need to show the goods or services receipt date (financial event) as the effective date of the delivered order, unpaid and accounts payable entry. The Director stated that the audit was completed prior to the implementation of a new accrual process that is documented in the Mechanization of Contract Administration Services accounts payable accrual procedure first used during the September 2007 end-of-month reporting. For recommendation number 4, the Director nonconcurred with the need to recognize unfunded liabilities, stating that under FAR 52.232-22 the Government is not legally obligated to pay the contractor unless the contracting officer increases the amount of funds on the contract. Therefore, it would be improper for DFAS to accrue a liability before DOD incurred a legal liability to pay a contractor for work he has performed.

**Audit Response.** We do not agree with the Director's comments on DoD IG Report No. D2007-059, “Vendor Pay Disbursement Cycle, Air Force General Fund,” February 9, 2007, recommendation 1 that a need does not exist for system changes and integration of systems in order to recognize transactions as of the date the financial events transpired. The need to properly recognize the date of financial transactions is a basic requirement of generally accepted accounting principles. While procedures may be established to estimate the accruals when actual information is not available, it does not eliminate the requirement to record

the information accurately if possible. We do not agree with the Director's comments to recommendation 2, and have included our response under Recommendation A.3 that follows. We are unable to respond to the comments on recommendation 3 because we have not performed audit work on the Mechanization of Contract Administration Services accounts payable accrual procedure being used by DFAS. An audit of the process would have to be performed to determine whether transactions are being properly recognized in the financial statements. We accept the Director's alternate response for this recommendation until another audit can be done. For recommendation 4, the Director's comment that FAR 52.232-22 does not create a legal liability contradicts FAR 52.232-22(l) which states that if funding is not provided, the contractor is entitled to a percentage of the Schedule fee equaling a percentage of the completion of the work contemplated by the contract, and FAR 32.704 (c) which states that Government personnel may not encourage a contractor to work at risk as it violates the Revised Statutes section 3679 (31 U.S.C. 1341).

## **Recommendations, Management Comments and Audit Response**

Deleted Recommendation. As a result of management comments, we deleted draft recommendation A.1.a.(2). Draft Recommendation A.1.a.(3) has been renumbered as Recommendation A.1.a.(2).

**A.1. We recommend that the Assistant Secretary of the Air Force (Financial Management and Comptroller), in coordination with the Assistant Secretary of the Air Force (Acquisition) and the Director, Defense Finance and Accounting Service:**

**a. Perform a thorough review of the internal control weaknesses reported in this report series in context to the criteria applied to each audit report and the facts presented in support of each deficiency. Such reviews should:**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of the recommendation. The Deputy stated that the guidance provided by the Federal Manager's Financial Integrity Act and Air Force Instruction 65-201, Manager's Internal Control Program procedures would be reiterated to the functional areas.

**(1) Complete preliminary Antideficiency Act reviews of the remaining deficiency (sample number 27) that violated appropriations law and regulation, as required in DoD Financial Management Regulation, volume 14, chapter 3, section 0304.**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) nonconcurred with the need to perform ADA reviews for the four sample numbers based on General Counsel review documents submitted. Furthermore, the Deputy questioned the type of sample used, random or judgmental, the use of contracts from the Integrated Accounts Payable System and Mechanization of Contract Administrative Services system, the ability to reach a high-risk conclusion from a sample of 45 contracting actions, and the criteria/parameters used for the sample taken. He also noted inherent differences between the Integrated Accounts Payable System and Mechanization of Contract Administration Services system, and commented that a Database Expansion and

Restructure which occurred in FY 2007 gave Integrated Accounts Payable System the ability to make payments at a more detailed level. Lastly, the Deputy suggested that we take a 45 contracting action sample from each system so that systemic weaknesses could be ascertained.

**Audit Response.** The Deputy Assistant Secretary, Financial Operations (Financial Management) comments are partially responsive. The additional documentation and information provided for sample numbers 11, 24, and 57 satisfy our concerns regarding those actions, and we have modified the report accordingly. However, the information provided by the Air Force is not sufficient to resolve sample number 27. The current comments regarding this sample state that the invoice provided to show work was performed in the period required is from a subcontractor. However, the Air Force did not provide documentary evidence to support that the company listed on the invoice was in fact an authorized subcontractor for the contract in question.

We do not agree with the Deputy Assistant Secretary's comments on the sample selected. We stated in the report that a random sample was used and that we only reviewed contracting actions with deliveries and payments made against the contracting actions during the period of October 2003 through June 2004. The origination of transactions in the Mechanization of Contract Administration Services system or Integrated Accounts Payable System is secondary to the findings presented, thus we do not believe that two additional sets of data need to be sampled as part of this audit.

**(2) Examine the accounting policies, procedures, and systems to bring the Air Force general ledger into compliance with the Federal Financial Management Improvement Act; Office of Management and Budget Circular A-127, "Financial Management Systems;" Federal Accounting Standards Advisory Board standards; and generally accepted accounting principles and guidelines.**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of the recommendation. He stated that they are currently working to bring their systems into compliance with the Air Force General Ledger and all other related financial policies.

**b. Take action to establish the policies, procedures, system changes and training necessary to mitigate the internal control risk identified in this series, based on the reviews conducted under recommendation A.1.a.(1)-(2).**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of the recommendation. He stated that Air Force Instruction 65-601, volume 2, chapter 1, "Role of Financial Analysis (Budget)" will be used to reemphasize proper financial management and to communicate budget concepts, policies, procedures and techniques.

**c. Include any previously unreported material internal control weaknesses identified as a result of recommendation A.1.a.(1)-(2) in the annual report required under section 3512, title 31, United States Code.**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of the recommendation. He stated that the Air Force does not have any unreported material weaknesses as a result of the audit recommendations.

**A.2. We recommend that the Assistant Secretary of the Air Force (Financial Management and Comptroller), in coordination with the Office of the Under Secretary of Defense (Comptroller) and the Office of the Under Secretary of Defense (Acquisition, Technology, and Logistics), address the Defense Finance and Accounting Service policy of determining whether a payment is for a cost reimbursement for services or contract financing by reviewing the deliverables rather than the relevant contract clauses.**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of the recommendation by stating that the Assistant Secretary of the Air Force (Financial Management and Comptroller) will coordinate with the other organizations to address this matter. He stated that the program manager of the funds should make the determination as to the deliverables and that his organization would work with the program managers to ensure the determination is clear prior to DFAS making payment.

**A.3. We recommend that the Director, Defense Finance and Accounting Service coordinate with the Office of the Under Secretary of Defense (Comptroller) to revise the accounting policies for foreign currency gains and losses.**

**Management Comments.** The Director, Corporate Reporting, Standards and Compliance, DFAS nonconcurred with the recommendation by citing that the Federal Accounting Standards Advisory Board has not established a policy addressing foreign currency fluctuations as outlined in this report. Furthermore, he stated that the DoD OIG's use of Statement of Financial Accounting Standards number 52 is inappropriate because that standard relates to foreign currency financial statement translation which DoD does not do.

**Audit Response.** We do not agree with the comments from the Director, Corporate Reporting, Standards and Compliance, DFAS. The Statement of Financial Accounting Standards number 52 addresses the translation of foreign currency transactions in addition to financial statements. Such transactions are clearly defined as "transactions denominated in a currency other than the entity's functional currency." DoD deals with such transactions as evidenced by the need for a foreign currency fluctuation account. In further defining foreign currency transactions, the standard states:

A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transactions. That increase or decrease in expected functional currency cash flow is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes. Likewise, a transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later) realized upon settlement of a foreign currency transaction generally shall be included in determining net income for the period in which the transactions is settled.

We request the Assistant Secretary of the Air Force (Financial Management and Comptroller) reconsider his position on recommendation A.1.a.(1) and the Director, Defense Finance and Accounting Service reconsider his position on recommendation A.3 and provide comments to the final report by May 12, 2008.

## **B. Interest Payments on Time-and-Materials and Labor-Hour Contracts**

DFAS erroneously processed time-and-materials and labor-hour (T&M/LH) contract interim payments containing materials as if they were subject to the Prompt Payment Act. DFAS paid interest resulting from a late payment without the regulatory and contractual authority. There are a number of contributing reasons why DFAS processed the contract payments in this manner. Specifically, DFAS:

- unilaterally interpreted section 1010 of the National Defense Authorization Act for FY 2001 (as amended by section 1007 of the National Defense Authorization Act for FY 2002) without seeking an advance decision;
- unilaterally and without authority determined it was in the best interest of the Government to pay interest on T&M/LH contracts; and
- had a long-standing practice of paying T&M/LH contracts as bureau voucher numbers (BVNs) which, when used to make interim payments, qualified them for the payment of interest if not paid on time.

As a result, DFAS improperly paid interest on one contracting action in violation of laws and regulations, thus exposing itself to a potential Antideficiency Act violation. A definitive legal opinion should be requested on this matter and appropriate actions taken in response to that opinion.

### **Time-and-Materials and Labor-Hour Contract Criteria**

**Section 1301(a), title 31, United States Code.** “Appropriations shall be applied only to the objects for which the appropriations were made except as otherwise provided by law.”

**Public Law.** Congress authorized payment of interest on cost-reimbursement contracts for services in section 1010 of the National Defense Authorization Act for FY 2001, as amended by section 1007 of the National Defense Authorization Act for FY 2002 (the Law). The Law required Federal agencies to pay interest when they made an interim payment on a cost-reimbursement contract for services more than 30 days after receiving a proper invoice for payment from the contractor.

**FAR Councils.** The FAR Councils issued a final rule with an effective date of February 12, 2007, related to the payment of interest on T&M/LH contracts. In the final rule, dated December 4, 2006, the FAR Councils amended FAR 52.232-7 (i) to authorize the Prompt Payment Act provision for interim payments related to the labor-hour portion of T&M/LH contracts. However, the FAR Councils noted their lack of authority to authorize payment of interest on supplies. Therefore, the FAR Councils amended paragraph (h) to clarify that interim payments on contracts for other than services remain as contract financing payments not subject to the Prompt Payment Act. The FAR Councils made the change because “the Prompt Payment Act applies to fixed-price and

cost-reimbursement contracts for services, it should also be applicable to T&M and LH contracts for services.”

**Federal Acquisition Regulation.** FAR Part 52.232-7, Payments under Time-and-Materials and Labor-Hour Contracts (December 2002), paragraph (h), stated that interim payments made prior to the final payment under the contract are contract financing payments which are not subject to the interest penalty provisions of the Prompt Payment Act. The February 2007 version of this FAR clause incorporates the aforementioned changes made as a result of the FAR Councils final rule. FAR Part 16, Types of Contracts, distinguishes between cost-reimbursement contracts and T&M/LH contracts by addressing the contract types in separate Subparts 16.3 and 16.6, respectively.

**Defense Federal Acquisition Regulation Supplement.** DFARS Part 216, Types of Contracts, also distinguishes between cost-reimbursement contracts and T&M/LH contracts by addressing the contract types in separate Subparts, 216.3 and 216.6, respectively.

**DoD Financial Management Regulation.** The FMR, volume 5, “Disbursing Policy and Procedures,” and volume 14, “Administrative Control of Funds and Antideficiency Act Violations,” November 2006, provide guidance related to advance decisions and the required response to potential ADA violations. See Appendix B for further explanation of the critical guidance applicable to this audit.

## Interest Paid

DFAS erroneously processed T&M/LH contract interim payments containing material costs as if they were subject to the Prompt Payment Act. DFAS paid interest on one voucher without regulatory and contractual authority. DFAS began processing the payment of interest on interim payments on T&M/LH contracts for the following reasons.

**Interest Decision Based on the Predominant Line Item.** The DFAS Audit Support and Attorney-Advisor provided explanations of why DFAS paid the interest. DFAS personnel used the following procedure to determine if an interim payment is subject to the payment of an interest penalty.

Interest is paid on late payments of vouchers that are identified as ‘Kind 6.’ Desk Procedure 201, “Contract Input” states that a contract should be placed into ‘Kind 6’ when a review determines that the contract contains predominantly service line items.

DFAS improperly coded one T&M/LH contracting action in our sample as “Kind 6 (services)”<sup>18</sup> subjecting all payments to potential interest charges. DFAS made this decision although the contracting action contained charges for materials that should not be subject to the payment of interest.

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<sup>18</sup> Sample number 7.



**Best Interest of the Government.** DFAS personnel commented they had the authority to pay interest on interim payments for T&M/LH contracts for services in accordance with FAR 1.102-4(e) and provided the following quote from that passage in the FAR:

If a policy or procedure, or a particular practice, is in the best interest of the government and is not specifically addressed in the FAR, nor prohibited by law (statute or case law), Executive order or other regulation, Government members of the Team should not assume it is prohibited. Rather, absence of direction should be interpreted as permitting the team to innovate and use sound business judgment that is otherwise consistent with law and within the limits of their authority....

FAR 1.102-4 references the role of the contract acquisition team. That section ends with “Contracting officers should take the lead in encouraging business process innovations and ensuring that business decisions are sound.” We agree FAR 1.102-4 gives the acquisition team latitude in making decisions that are in the best interest of the Government, but we do not agree that DFAS personnel are acquisition team members, as intended and established by FAR 1.102-4. However, even if DFAS personnel were members of an acquisition team, FAR 1.102-4(e) requires the contracting officers to ensure the business decisions were sound. That would have required DFAS personnel to coordinate with the contracting officers.

**Long-standing Practice.** DFAS has a long-standing practice to pay T&M/LH contracts as BVNs. A DFAS representative stated:

DFAS does, however, interpret the meaning of contracts as issued and modified by contracting officers when it makes its entitlement decisions. There is a very long-standing practice to pay these T&M LH contracts based upon BVN’s rather than invoices. DFAS believes that this course of dealing would make it very difficult for the contracting offices to now take the position that billing on BVN’s on T&M LH contracts is not permissible and that acceptance is a prerequisite for payment.

The DFAS representative concluded:

DFAS has decided that a T&M LH contract billed on a BVN is per se a cost-type contract for purposes of the Prompt Payment Act, both with regard to Prompt Payment Act interest and the inapplicability of the cash management rules. If the contract is for services, Prompt Payment Act interest will be applicable if the payment is not made within the period prescribed by the statute.

The statement that T&M/LH contracts have historically been processed as BVNs has no bearing on entitlement under the Law. The Law did not state interest was payable on interim payments paid by BVN. We do not believe DFAS has the authority to interpret contracts and make a unilateral decision on entitlement. The previously cited FAR sections and FAR Councils final rule clearly distinguish between cost-reimbursement contracts for services and T&M/LH contracts, thus DFAS should have requested an advance decision prior to paying any interest on T&M/LH contracts with costs for materials.

DFAS unilaterally, and without proper authority, paid interest in violation of law and regulation. We were unable to clearly establish a line of authority and

accountability for the actions taken. Therefore, unless the amount is recovered, DFAS violated the Purpose Statute, section 1301(a), title 31, United States Code, which may result in a potential ADA violation.

## **Recommendations, Management Comments and Audit Response**

**B.1. We recommend that the Director, Defense Finance and Accounting Service request the Office of the Secretary of Defense, Office of General Counsel for a definitive legal opinion related to the legal or administrative authority for Defense Financial Accounting Service to make interest entitlement decisions based on the predominant contract line item.**

**Management Comments.** The Director, Corporate Reporting, Standards and Compliance, DFAS partially concurred with our recommendation stating that a legal opinion would be requested from the DFAS Office of General Counsel by January 1, 2008. On December 21, 2007, DFAS provided updated comments for this recommendation stating that the DFAS Deputy Assistant General Counsel, Accounting and Commercial Law provided a legal opinion on December 20, 2007. The legal opinion contained excerpts from regulations and DFAS stance that “the issue of whether most of the effort on a contract is for services would logically be a very important consideration that the paying office would use in determining whether a contract is a “contract for services” and whether interest were payable.” The Deputy Assistant General Counsel, Accounting and Commercial Law cited DoD FMR, volume 10, chapter 7, paragraph 070301 and stated that “the disbursing office, if it determines that the payment is an interim payment on a cost reimbursement contract for services, must make the interest payment....”

**Audit Response.** The Director, Corporate Reporting, Standards and Compliance, DFAS comments do not resolve this recommendation. We do not agree with the DFAS Columbus Deputy Assistant General Counsel’s interpretation of the FMR. Section 070301 states that when interest is due, DFAS will pay it without requiring the contractor to ask for it. Paragraph 070101 of that same volume states that if there is a conflict between the payment terms in the contract and the provisions of the Prompt Payment Act, the disbursing office is to request clarification from the responsible contracting officer. Because this is an interpretation of DoD policy, we reiterate that a legal opinion is needed from the Office of the Secretary of Defense, Office of General Counsel.

**B.2. We recommend that the Director, Defense Finance and Accounting Service:**

**a. Revise Defense Finance and Accounting Service policies, procedures, and guidelines based on the definitive opinion of the Office of the Secretary of Defense, Office of General Counsel, provided in response to Recommendation B.1.**

**Management Comments.** The Director, Corporate Reporting, Standards and Compliance, DFAS concurred with the recommendation by agreeing to make any necessary changes resulting from the decision provided by DFAS Office of General Counsel.

**Audit Response.** The Director, Corporate Reporting, Standards and Compliance, DFAS comments are partially responsive. As stated in recommendation B.1, the legal opinion must come from the Office of the Secretary of Defense, Office of General Counsel.

**b. Establish procedures and automated system controls to segregate the material and labor portions of time-and-materials and labor-hour contract interim payments to prevent the payment of interest on the material portion.**

**Management Comments.** The Director, Corporate Reporting, Standards and Compliance, DFAS nonconcurred with the recommendation by citing various regulations. He noted that Public Law 106-398, 114 Stat. 1654 states that an agency acquiring services under a cost-reimbursement contract requiring interim payments that does not pay by the due date must pay an interest penalty on the payment amount. The Director also stated that 5 C.F.R. 1315.20 further supports that an interest penalty is due on a late payment under a cost-reimbursement service contract, and that FAR 52.232-7 establishes that, although time-and-materials and labor-hour contracts are for some purposes distinguishable, for purposes of Prompt Payment Act interest they are treated the same. According to the Director, DFAS does not have the authority to engage in a payment-by-payment analysis and pay or not pay interest based upon the characteristic of the specific item, and whether the payment is for services or goods is irrelevant to this analysis. According to the Director, the decision is made at the contract level in compliance with FAR 52.232-7(h) which states that the Prompt Payment Act applies to “interim payments on contracts for services,” but not “interim payments on contracts for other than services.”

**Audit Response.** The Director, Corporate Reporting, Standards and Compliance, DFAS comments do not resolve this recommendation. We do not agree that FAR 52.232-7 establishes that time-and-materials and labor-hour contracts are treated the same as cost reimbursement service contracts for purposes of the Prompt Payment Act. FAR 52.232-7 applies to all “Payments under Time-and-Materials and Labor-Hour Contracts.” Paragraph (h) of that section states that interim payments made prior to the final payment under time-and-materials and labor-hour contracts for other than services are contract financing payments and are not subject to the interest penalty provisions of the Prompt Payment Act. The final rule changing this clause was issued by the Civilian Agency Acquisition Council and Defense Acquisition Regulations Council (the Councils) and published in the Federal Register on December 12, 2006. As part of the public comments to the proposed change, a respondent asked the Councils to “Revise the rule to permit Prompt Payment Act interest also on the material portion of T&M contracts.” The Councils stated that “The Prompt Payment Act applies to fixed-price contracts and interim payments on cost-reimbursable contracts for services. The Councils lack the authority to extend the Act to interim payments for supplies.” Therefore, this clause requires that DFAS make a payment-by-payment analysis and pay interest based on what is being purchased. The same final rule that amended FAR 52.232-7 also amended FAR 16.307(a)(1) to state, “If the contract is a time-and-materials contract, the clause at 52.216-7 applies only to the portion of the contract that provides for reimbursement of materials (as defined in the clause at 52.232-7) at actual cost.” This is further evidence that the materials portion of these contracts must be treated separately.

We request the Director, Defense Finance and Accounting Service reconsider his position on recommendations B.1, B.2.a, and B.2.b and provide comments by May 12, 2008.

## C. Liability Recognition

Delayed subcontractor's billing caused the prime contractor to include appropriations that were no longer available when he billed the Government on a time-and-materials and labor-hour (T&M/LH) contract.<sup>19</sup> Air Force personnel indicated that the contractor incurred the costs in an earlier period, but could not bill the Government until FY 2004 because the subcontractor had not submitted its invoices for payment. DFAS paid the prime contractor in FY 2004 with the prior year funds, but neither Air Force nor contractor personnel could provide documentation proving the work was done during that time period. Because this was a T&M/LH contract, we believe that the Government did not incur a liability until the prime contractor actually received the bill from the subcontractor. However, guidance on the posting and recognition of liabilities associated with contractor-incurred costs of prime and subcontractors is not clear. Therefore, we believe that a legal opinion is necessary to determine whether the Government should be recording the third-party liability for subcontractors work on T&M/LH contracts.

### Criteria for Liability Recognition

**Federal Acquisition Regulation.** The principal FAR clause that relates to the contracting action cited in this finding is FAR 52.232-7, "Payments under Time-and-Materials and Labor-Hour Contracts." That clause states "contractors are authorized reimbursement of the reported costs incurred that have been paid by cash (or other negotiable instrument) and for subcontract supplies and services directly purchased for the contract that will be paid by the contractor within 30 days."

**Federal Accounting Standards Advisory Board.** FASAB issued the Statement of Federal Financial Accounting Standards, No. 1, "Accounting for Selected Assets and Liabilities," March 30, 1993. Regarding recognition of the accounts payable, FASAB observes:<sup>20</sup>

For facilities or equipment constructed or manufactured by contractors or grantees according to agreements or contract specifications, amounts recorded as payable should be based on an estimate of work completed under the contract or the agreement. The estimate of such amounts should be based primarily on the federal entity's engineering and management evaluation of actual performance progress and incurred costs.

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<sup>19</sup> Sample number 26, contract F19628-02-F-8197.

<sup>20</sup> We recognize the FASAB reference to facilities and equipment, constructed or manufactured, does not apply to contract F19628-02-F-8197. However, we believe the principle of estimating the work performed, based on progress and incurred cost reports, is germane.

FASAB also states: “For financial reporting purposes, liabilities are recognized when goods and services are received or are recognized based on an estimate of work completed under a contract or agreement.”

**DoD Financial Management Regulation.** The DoD FMR presents regulations related to the general ledger and accounts payable. See Appendix B for further discussion of relevant sections of the FMR.

## Incurred Cost Recognition

Delayed subcontractor’s billing caused the prime contractor to include appropriations that were no longer available when he billed the Government on a T&M/LH contract. Air Force personnel stated the contractor incurred the costs during an earlier period, but could not bill the Government until FY 2004 when the subcontractor submitted the invoices and was paid by the contractor. DFAS paid the contractor with the prior year funds that were identified on the contractor’s invoice, but neither DFAS nor Air Force personnel could provide documentation supporting the date the work was done. Because this was a TM&LH contract, we believe that the Government did not incur a liability until the prime contractor actually received the bill from the subcontractor.

Specifically, in our first audit report in this series,<sup>21</sup> we reported a potential ADA violation related to the contract after determining DFAS used FY 2001 and FY 2002 Research, Development, Test, and Evaluation funds to reimburse the contractor for costs reported in April 2004. If the FY 2001 and FY 2002 funds were used to pay for costs incurred in FY 2004, the goods or services were not a bona fide need of those years. However, in management’s comments on the first report, Air Force personnel stated the FY 2001 and FY 2002 Research, Development, Test, and Evaluation appropriations were properly used because the subcontractors, who had delayed billing for services, actually performed the services in the years that the FY 2001 and FY 2002 funds were available for obligation. In our followup to those comments, we requested the Air Force and contractor provide copies of the subcontractor billings to support when performance occurred. Neither Air Force nor contractor personnel were able to provide the documentation. As a result, we recommend a preliminary ADA review.

## Definitive Guidance

Definitive DoD guidance on the posting and recognition of liabilities associated with contractor-incurred costs of prime and subcontractors is not available. The FASAB, SFFAS No. 1, “Accounting for Selected Assets and Liabilities,”

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<sup>21</sup> Report on Vendor Pay Disbursement Cycle, Air Force General Fund: Contract Formation and Funding (D-2006-056), March 6, 2006.

March 30, 1993, provides for the Government to account for incurred cost as accounts payable.

This area of contractor-incurred cost requires considerable research of the legal, payment, budgetary, accounting, and system requirements; contractual payment instructions; and administrative procedures and training of program-level and base-level personnel. Specifically, before DoD can answer the question of how to account for the incurred costs, it needs to determine whether there is a legal basis for the Government to recognize third party liabilities that exist between a prime contractor and subcontractors.

## **Discussion of Effect**

If it is determined that the Government does not have a liability until the prime contractor recognizes the liability, then a preliminary ADA investigation should still occur on this contracting action. The prime contractor did not receive the questionable billings from the subcontractor until FY 2004; however, the direct submission indicated the disbursement should be made from FY 2001 and FY 2002 appropriations. If it is determined that the date the subcontractor completed the work is the date of the Government's liability, we would request the Air Force or contractor provide documentation from the subcontractor that the work occurred in FY 2001 and FY 2002. In addition, Air Force personnel should review procedures to determine how to record unrecognized liabilities related to subcontractor-incurred costs on time-materials and labor-hour contracts.

## **Recommendations**

**C.1. We recommend that the Assistant Secretary of the Air Force (Financial Management and Comptroller) request the Office of the Secretary of Defense, Office of General Counsel for a definitive legal opinion concerning the recognition of the Government's liabilities for costs incurred by subcontractors on time-and-materials and labor-hour contracts.**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of the recommendation. The Deputy stated that Air Force protocol requires an Air Force General Counsel opinion on this matter. The Air Force General Counsel agreed with the Major Command General Counsel opinion and is responsible for obtaining an Office of the Secretary of Defense, Office of General Counsel opinion.

**C.2. We recommend that the Assistant Secretary of the Air Force, Financial Management and Comptroller) initiate one of the following actions based on the legal opinion provided in Recommendation C.1.**

**a. If the Office of General Counsel determines that the Government does not have a liability until the prime contractor receives the bill from the subcontractor, a preliminary ADA investigation should be initiated.**

**b. If it is determined that the date the subcontractor completed the work is the date of the Government's liability:**

**(1) Provide documentation from the subcontractor that the work occurred in FY 2001 and FY 2002.**

**(2) Review and revise procedures to determine how to record unrecognized liabilities related to subcontractor-incurred costs on time-and-materials and labor-hour contracts.**

**Management Comments.** The Deputy Assistant Secretary, Financial Operations (Financial Management) concurred with the intent of the recommendation. Upon notification by Air Force General Counsel, the Deputy stated that the Air Force will take required action.

# Appendix A. Scope and Methodology

We conducted this financial audit 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.

This is the fifth and final report in a series of reports examining internal control and compliance with laws and regulations of the Air Force General Fund vendor pay disbursement cycle. In this report, we summarize management's comments made to the first four reports in this series and provide two followup findings related to the first and third reports in the series.

In our examination of the 45 contracting actions (which included funding modifications), we examined the contract file documentation for each sample to determine the timing, nature, character, and terms and conditions related to the action as a financial event. We also obtained copies of the funding documents for the contracting action. Based upon the contract data gathered, we traced the delivery of the goods or services through receipt and acceptance by the Government, invoice certification, payment, and recognition of the related transactions in the budgetary and proprietary general ledger accounts in the official accounting records.

We performed the four previous audits from January 2004 through May 2006, and this followup audit on the findings and recommendations from August 2006 through July 2007. Our review of the transactions and the financial events related to the deliveries and payments made against the contracting actions during the period October 2003 through June 2004, except for those actions that were funding modifications. We reconstructed the funding and payment histories for all funding modifications back to the inception of the basic order or contract. Because of the length of time that transpired in the completion of this audit and the report series, we followed up with personnel in April 2007 to determine whether management had taken corrective action to the deficiencies identified in this report.

**Use of Computer-Processed Data.** We relied on data from the General Accounting and Finance System–Rehost, General Accounting and Finance System–Base Level, Integrated Accounts Payable System, Mechanization of Contract Administration Services, and Electronic Document Access systems. However, we did not perform a formal reliability assessment of those systems. Instead, we compared the system data by tracing the hardcopy contract, funding, invoices, receiving documents, and payment vouchers to the transactions recorded in the accounting system.

**Use of Technical Assistance.** The Office of General Counsel, Office of the Inspector General, assisted in the review of the legality of the contracting actions and funds used to pay vendors identified in this report. In addition, personnel from the Quantitative Methods Division, Office of the Inspector General, assisted in the development of the statistical analysis presented in this report.

**Government Accountability Office High-Risk Area.** The Government Accountability Office has identified several high-risk areas in DoD. This report addresses issues related to the Defense Financial Management high-risk area.



## **Prior Coverage**

During the last 5 years, DoD IG has issued four reports related to the Air Force General Fund vendor pay disbursement cycle. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

## **DoD IG**

DoD IG Report No. D-2007-059, “Vendor Pay Disbursement Cycle, Air Force General Fund: Financial Accounting,” February 9, 2007

DoD IG Report No. D-2007-027, “Vendor Pay Disbursement Cycle, Air Force General Fund: Payments to Vendors,” November 24, 2006

DoD IG Report No. D-2006-085, “Vendor Pay Disbursement Cycle, Air Force General Fund: Funds Control,” May 15, 2006

DoD IG Report No. D-2006-056, “Report on Vendor Pay Disbursement Cycle, Air Force General Fund: Contract Formation and Funding,” March 6, 2006

## **Appendix B. DoD Financial Management Regulation Guidance**

**DoD Financial Management Regulation (FMR) provides guidance applicable to this audit. Volumes 1 and 4 relate to finding C of this report; Volumes 5 and 14 relate to finding B; and Volume 14 also relates to finding A.**

FMR, volume 1, chapter 7, section 070702 states “An entry to record delivered orders unpaid in budgetary accounts requires a corresponding entry to record accounts payable in proprietary accounts.”

FMR, volume 4, chapter 9, section 090201 states the following regarding the recognition of accounts payable resulting from ongoing shipbuilding or construction of facilities:

Accounts payable resulting from ongoing shipbuilding or construction of facilities is based on the percentage of completion of the project.... The accounts payable is recognized because formal acceptance of the final product by the DoD Component is not the determining factor for accounting recognition. The DoD Component acquires an asset during each accounting period based on constructive or de facto receipt and should recognize an accounts payable during each accounting period.

FMR, volume 5, chapter 1, section 010302 states that a pre-payment examination is to ensure that vouchers contain the necessary substantiation and documentation for lawful and proper payment. The pre-payment examination includes: (1) validating the payment is permitted by applicable law or regulation, and (2) assuring the request for payment is supported by basic documents. Section 010801 states “a DO [disbursing officer], certifying officer, or departmental accountable official should seek the advice of the appropriate office, depending on the nature of the issue (see Appendix E), when they are in doubt about the legality of authorizing the obligation or payment of government funds.” Appendix E to volume 5 states that advance decisions on the use of appropriated funds be made by the Office of the Secretary of Defense, Office of the Deputy General Counsel (Fiscal).

FMR, volume 14, chapter 3, section 0304 states:

In some cases, the General Accounting Office; Inspector General (IG), DoD; a Military Department Audit Agency; or other organizations external to a DoD Component may advise in a report that a potential [Antideficiency Act] violation may have occurred.... Within 10 business days of receipt of a draft report that alleges a potential violation, the Office of the Under Secretary of Defense (Comptroller), the Assistant Secretary for Financial Management of a Military Department or the Comptroller of a Defense Agency or DoD Field Activity, as applicable, shall request that a preliminary review of the potential violation be initiated within the next 30 days.

## Appendix C. Contracting Actions Selected for Review

CONTRACTING ACTION NUMBER	SAMPLE NUMBER	CONTRACTING OFFICE	CONTRACTING ACTION	CONTRACT VALUE	DESCRIPTION GOODS/SERVICES
1	1	WR-ALC / LRK 750 3rd Street Robins AFB, GA 31098-2122	F34601-00-G-0006 RU32	319,431	Miscellaneous Engine Accessories, Aircraft
2	2	Air Force Material Command Aeronautical System Center 2640 Loop Road West, Building 557 Wright-Patterson AFB, OH 45433-7106	F33657-00-G-4029	645,500	Airframe structural components
3	3	OO-ALC / LGJ 6050 Gum Lane, Building 1215 Hill AFB, UT 84056-5825	GS-07F-7465C F42630-03-F-0059	677,385	Converters, Electrical, Nonrotating
4	4	Air Force Material Command Human System Center / PKR 7909 Lindbergh Drive Brooks AFB, TX 78235-5352	F41624-97-D-6004	112,000	RDT&E Other Research and Development-Eng. / Manuf. Development
5	5	Air Force Material Command Air Force Research Laboratory 2310 8th Street, Building 167 Wright-Patterson AFB, OH 45433-7801	F33615-03-M-2385	99,661	RDT&E / Aircraft-Applied Research
6	6	55 Contracting Squadron 101 Washington Square, Building 40 Offutt AFB, NE 68113-2107	F25600-02-D-0008	319,972	Automated Information System Design and Integration Services
7	7	OC-ALC/PSK B-52 3001 Staff Drive Building 3001, Suite 2AG87A Tinker AFB, OK 73145-3020	F34601-99-C-0006 P00130	75,000	Systems Engineering Services
8	10	ASC/PKW Area C Building 1 1940 Allbrook Drive, Suite 3 Wright-Patterson AFB, OH 45433-5309	NIH-26303D0541 F33600-03-F-3217	68,570	ADP Support Equip
9	11	18 CONS / Infrastructure Acquisition Unit 5199, Building 95 Kadena AB—Japan APO, AP 96368	F62321-00-D-0007	142,185	Maintenance / Other Miscellaneous Buildings
10	12	Department 8, AF Research Laboratory Directorate of Contracting / PK 2251 Maxwell Avenue SE Kirtland AFB, NM 87117-5773	F29601-97-C-0115 P00065	106,600	RDT&E / Weapons-Adv Tech Devopment
11	14	39 CONS / LGC FA5685 39 Uncu Kontrat Subayligi Bina Number 488, 10 Uncu Tanker US Incirlik/Adana, Turkey	F61358-03-P-0104	128,750	Aircraft Ground Servicing Equipment
12	17	R325 CONS / LGCB / STOP 28 501 Illinois Avenue, Suite 5 Tyndall AFB, FL 32403-5526	F08637-02-D-6999	680,028	Facilities Operations Support Services
13	18	OC-ALC / PKOAA 7858 5th Street, Suite 1 Tinker AFB, OK 73145	NAS501142 F34650-03-F-A384	148,127	ADPE System Configuration
14	19	Directorate of Contracting Building 1206, OO-ALC / LHKC 6039 Wardleigh Road Hill AFB, UT 84056-5838	F42600-01-D-0027	3,688,503	Systems Engineering Services
15	20	AAC / YUB Building 11, 102 W. D Avenue, Ste 300 Eglin AFB, FL 32542-6808	F08635-03-D-0007	195,626	Bombs

Note: Sample numbers are not in consecutive order. Twelve contracting actions resulting in deliveries and payment prior to October 1, 2003 were replaced.

CONTRACTING ACTION NUMBER	SAMPLE NUMBER	CONTRACTING OFFICE	CONTRACTING ACTION	CONTRACT VALUE	DESCRIPTION GOODS/SERVICES
16	21	Air Force Material Command 311th Human Systems Wing / PKV 3300 Sidney Brooks Brooks City Base, TX 78235-5112	F41624-01-D-8552	99,461	Other Industrial Buildings
17	22	OO-ALC / YWK Directorate of Contracting Building 1215, 6050 Gum Lane Hill AFB, UT 84056-5825	F42630-99-C-0170 P00085	56,862	Maintenance and Repair of Equipment / Training Aids and Devices
18	23	Contracting Squadron IT 14040 Building 17000 Andersen AFB, GU 96543-4040	F64133-03-P-0242	89,708	Miscellaneous Items
19	24	CONS / Infrastructure Acquisition Unit 15199, Building 95 Kadena AB—Japan APO, AP 96368	F62321-03-D-0010	83,345	Maintenance / Other Miscellaneous Buildings
20	25	OC-ALC Directorate of Contracting / Aircraft 3001 Staff Dr, Suite 1AE1 107B Tinker AFB, OK 73145-3020	F34601-97-C-0032 P00126	587,000	Aircraft Fixed Wing
21	26	ESC / SRK Electronic Systems Center Air Force Material Command Hanscom AFB, MA 01731-3010	GS-35F-4668G F19628-02-F-8197 P00010	1,508,316	Other Professional Services
22	27	374 Contracting Squadron Unit 5228, Building 620 Yokota AB—Japan Fussa-Shi, Tokyo 197-0001	F62562-03-C-0049	620,200	Maintenance / Religious Facilities
23	28	AAC / PKO-FA2823 205 West D Avenue Building 350, Suite 541 Eglin AFB, FL 32542-6862	GS-07F-0397K F08651-03-F-A294	68,995	Recreational and Gymnastic Equipment
24	30	Air Force Material Command HQ Aeronautical Systems Center 2300 D Street Wright-Patterson AFB, OH 45433-7249	F33657-98-D-0021	876,488	Data Analyses (Other Than Scientific)
25	31	OO-ALC / PKOS 6038 Aspen Ave, B1289 NE Hill AFB, UT 84056-5805	F42650-02-C-0024 P00013	250,000	Custodial-Janitorial Services
26	32	82 CONS / LGC 136 Avenue, Ste 1, Building 1664 Sheppard AFB, TX 76311-2746	F41612-01-D-0006	573,366	Maintenance / Maintenance Building
27	33	374 Contracting Squadron Unit 5228, Building 620 Yokota AB—Japan Fussaa-Shi, Tokyo 197-0001	F62562-03-P-0648	42,085	Maintenance / Family Housing Facilities
28	34	88 ABW / PKS 1940 Allbrook Drive, Suite 3 Wright-Patterson AFB, OH 45433-5309	GS-28F-8021H F33601-03-F-0228	67,770	Office Furniture
29	35	USAFE Contracting Squadron Unit 3115 APO, AE 09094	GS-06F-0007J F61521-03-F-A494	206,530	Miscellaneous Items
30	36	OC-ALC / PKOE 7858 5th Street, Suite 1 Tinker AFB, OK 73145	F34650-98-D-0033	124,359	Architect - Engineering Services

Note: Sample numbers are not in consecutive order. Twelve contracting actions resulting in deliveries and payment prior to October 1, 2003 were replaced.

CONTRACTING ACTION NUMBER	SAMPLE NUMBER	CONTRACTING OFFICE	CONTRACTING ACTION	CONTRACT VALUE	DESCRIPTION GOODS/SERVICES
31	37	99 CONS / LGCB 5865 SWAAB Boulevard, Building 588 Nellis AFB, NV 89191-7063	GS-35F-4076D F26600-03-F-8613	486,000	ADP Input / Output and Storage Devices
32	38	35 CONS / LGC Unit 5201, Building 302 (Japan) APO, AP 96319-5201	GS-07F-8756D F62509-03-F-0067	77,173	Tractor, Wheeled
33	40	38 Contracting Squadron Unit 14040, Building 17000 Andersen AFB, GU 96543-4040	F64133-98-D-0009	128,590	Maintenance / Other Miscellaneous Buiding
34	41	Air Force Material Command Aeronautical Systems Center 2640-Loop Road West, Room 213 Wright-Patterson AFB, OH 45433-7106	F33657-03-C-3003 P00016	3,232,511	Drones
35	42	15th Contracting Squadron 90G Street, Building 1201 Hickam AFB, HI 96853-5230	F64605-03-C-0020	1,499,980	Maintenance / All Other Non-Building Facilities
36	44	Special Operations Forces Contracting Division WR-ALC / IUK 228 Cochran Street Robins AFB, GA 31098-2200	F09603-02-C-0286 P0007	442,297	Modification of Equipment / Aircraft Components & Accessories
37	46	Air Force Material Command Aeronautical Systems Center 2640 Loop Rd West, Rm 203 Wright-Patterson AFB, OH 45433-7106	F33657-00-G-4042	85,371	Systems Engineering Services
38	47	ASC / PKW Area C, Building 1 1940 Allbrook Drive, Suite 3 Wright-Patterson AFB, OH 45433-5309	F42620-00-D-0039 RZ16	71,092	Engineering Technical Services
39	48	OC/ALC / LGKIB (CFT) 3001 Staff Drive, Suite 1AC197E Tinker AFB, OK 73145-3028	F34601-97-D-0423	1,130,678	Maintenance and Repair of Equipment / Aircraft Structural Comps
40	50	12 CONS / LGCB-FA1691 395 B Street West, Suite 2 Randolph AFB, TX 78150-4525	GS-35F-4415G F41691-02-F-0653 P00001	74,630	Other ADP & Telecommunication Services
41	51	OO-ALC / LHKS Directorate of Contracting Building 1239, 6012 Fir Avenue Hill AFB, UT 84056-5820	F04606-97-D-0059 QPSB	317,027	Telephone & Telegraph Equipment
42	53	42nd Contracting Squadron 50 Lemay Plaza South Maxwell AFB, AL 36112-6334	F01600-03-F-A306	149,160	Office Furniture
43	54	22nd Contracting Squadron, FA4621 53147 Kansas Street, Suite 102 McConnell AFB, KS 67221-3606	DAHA14-02-D-5222 X406	168,272	Maintenance Religious Facilities
44	56	Air Force Material Command Air Armament Center Building 349 207 West D Avenue, Suite 622 Eglin AFB, FL 32542-6844	F08635-03-C-0098	2,500,000	Guided Missiles
45	57	50th Contracting Squadron, GWE 21D Falcon Parkway Schriever AFB, CO 80912-2118	GS-07F-6337A FA2550-03-F-A122	199,943	Miscellaneous Fumiture and Fixtures
Note: Sample numbers are not in consecutive order. Twelve contracting actions resulting in deliveries and payment prior to October 1, 2003 were replaced.					

# **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 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)  
Assistant Secretary of the Air Force (Acquisition)  
Auditor General, Department of the Air Force

## **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  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Oversight and Government Reform

# Department of the Air Force Comments

Final Report  
Reference



OFFICE OF THE ASSISTANT SECRETARY

DEPARTMENT OF THE AIR FORCE  
WASHINGTON, DC

26 Oct 07

MEMORANDUM FOR MEMORANDUM FOR MEMORANDUM FOR DEPUTY  
INSPECTOR GENERAL FOR AUDITING OFFICE OF THE  
INSPECTOR GENERAL DEPARTMENT OF DEFENSE

FROM: SAF/FMP  
1130 Air Force Pentagon  
Washington, DC 20330-1130

SUBJECT: DoDIG Draft Audit Report, Vendor Pay Disbursement Cycle, Air Force General  
Fund (Projects D2004FD-0040.004)

This is in reply to your memorandum requesting Assistant Secretary of the Air Force  
(Financial Management and Comptroller) to provide comments on subject report.

Recommendations A.1, and A.2 (Concur With Intent) The Deputy Assistant Secretary  
Financial Management (Financial Operations) "Concurs With Intent" on the above  
recommendations in Audit Report D20004FD-0040.004, page 12. The recommendations  
address three different agencies and we will do our best to provide you with appropriate  
comments relating to the Air Force Financial Management function. In accordance with  
DoD7600.7-M June 1990, *Department of Defense Audit Manual*, draft reports are required to be  
staffed through the management officials responsible for taking corrective action. However, this  
report's audit recommendations are not specifically directed to the corrective subject matter area  
and it is difficult to pull out the recommendations specifics, therefore rendering the  
recommendation(s) to our interpretation. The recommendations in this report address a  
combination of issues that require action and others that require just a response.

A.1.a. This comment addresses the action of performing an internal control weakness  
review reported in the report series and lists three reviews to perform. Criteria (internal control)  
are in place to assure that we are in compliance with applicable laws and regulations. To meet  
Federal Managers Financial Integrity Act (FMFIA), AF165-201, *Manager's Internal Control  
Program Procedures*, provides structure to establish, evaluate and report on Air Force internal  
controls in all functional areas. We will reiterate this policy to our functional areas.

A.1.a.(1). Preliminary ADA reviews for the five sample numbers were not necessary  
based on a General Counsel review (Attachments 1-5). Additionally, the sample taken does not  
specify as to a random or judgmental sample of contracts and within this sample we detected  
some inconsistencies existed because the 45 sampled contracts were extracted from two different  
paying systems, Integrated Accounts Payable System (IAPS) and Mechanization of Contract  
Administrative Services (MOCAS). The IAPS recently had enhancements, Database Expansion

Attachments  
Not Included

Deleted

2

and Restructure (DEAR FY2007), which now gives the system the ability to make payments at a more detailed level. The IAPS is considered a local vendor payment system, whereas MOCAS is an acquisition system used to make high dollar payments, as well as progress payments (a type of contract financing). The sample size itself was enough to bring certain weaknesses visible, but not enough to determine such a high-risk conclusion. Further, an auditor's note on pages 24-26 states "Twelve contracting actions resulting in deliveries and payment prior to October 1, 2003 were replaced". Why? Again there were no criteria/parameters provided as to the type of sample taken. We suggest another sample be taken and establish criteria as to the type of sample and the sample size (45) be taken from both systems so that we can determine any systemic weaknesses.

A.1.a.(2). In our interpretation we did not identify any conflicting comments provided by Financial Management. We are providing this document to support our comments to the nonconcurring comments.

A.1.a.(3). We are currently working our Accounting Policies and Compliance to bring our systems into compliance with the Air Force General Ledger and all other related financial policies.

A.1. b. The audit report addresses the "funds holder" and "resource managers" as having the responsibility for maintaining a system of positive funds control. The recommendation should be broken down to address the issues associated with each respective area cited in the recommendation. In addition, the Air Force has established guidance, however updating our procedures may need to be evaluated. The term "fund holders" is synonymous with Program Manager (located at their respective base/installation) in that the funds holder is responsible for the day-to-day management of his/her funds. Each functional Air Force area has responsibility for their funds management; therefore the responsibility of managing those funds is under the respective functional area. The Assistant Secretary of the Air Force Financial Management, Deputy Assistant Secretary for Budget policy (AF165-601V2, Chapter 1, *The Role of Financial Analysis (Budget)*) will be reemphasize to ensure proper financial management at all levels and communicate current budget concepts, policies, procedures and techniques to the resource managers. The Air Force Financial Management community needs to be more cognizant of these training issues and ensure that all program managers, resource managers and/or fund holders are provided appropriate training. We can reiterate our policies through Financial Management Calls, Financial Working Group meetings, and professional development seminars. Additionally, each functional area has a budget analyst responsible for the functional area's program. The budget analyst's purpose is to provide proprietary of funding over the funds holder account.

A.1.c. All material internal control weakness are identified in our Annual Statement of Assurance, published in September. No unreported material weaknesses as a result of the audit recommendations were identified specifically as Air Force in the report. We agree that there may be some Payment Process issues; however this Audit Report addresses a broad area of Financial Management, to include DFAS, OSD(C) and Air Force Financial Management processes.



3

A.2. The Assistant Secretary of the Air Force (Financial Management and Comptroller) will coordinate to the best of their ability with the other two agencies to address whether a payment is for cost reimbursement for services or contract financing by reviewing the deliverables; however, financial management personnel are not acquisition specialists and therefore the program manager (PMs) of the funds should make that determination on the deliverables. Since this audit did not give specifics as to the functional area, we will work with PMs to ensure that this determination is clear prior to DFAS making payment.

Thank you for the opportunity to comment on this report. If you have any questions or require additional information, please contact Ms. Karen Thomas, SAF/FMPF, 703-697-6052, DSN 227-6052, [Karen.Thomas@pentagon.af.mil](mailto:Karen.Thomas@pentagon.af.mil).

  
RICHARD P. GUSTAFSON  
Deputy Assistant Secretary  
Financial Operations  
(Financial Management)

Attachments:

1. Samples 11 and 24
2. Sample 26
3. Sample 27
4. Sample 57

Attachments  
Not Included



DEPARTMENT OF THE AIR FORCE  
WASHINGTON DC

23 JAN 2008

Office Of The Assistant Secretary

MEMORANDUM FOR THE ASSISTANT INSPECTOR GENERAL FOR AUDITING  
OFFICE OF THE INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE


FROM: SAF/FMP  
1130 Air Force Pentagon  
Washington, DC 20330-1130

SUBJECT: Response to Audit Report D2004-D00FD-0040.004, Recommendation C

Recommendations C.1 and C.2 (Concur with Intent) The Deputy Assistant Secretary Financial Management, Financial Operations (SAF/FMP) "Concurs With Intent" on the above recommendations in Audit Report D2004FD-0040.004, page 19. The recommendations suggest that the Assistant Secretary of the Air Force Financial Management and Comptroller request the Office of the Secretary of Defense, Office of General Counsel for a definitive legal opinion concerning the recognition of the Government's liabilities for costs incurred by subcontractors on time-and-material and labor hour contracts. Proper Air Force protocol calls for the Air Force to utilize Air Force General Counsel (GC) in matters requesting a legal opinion. With that said we obtained a MAJCOM GC opinion and forwarded to the SAF GC, who concurred with the MAJCOM GC position. It is now the Air Force's GC responsibility to contact the OSD GC for their opinion in this matter. We have provided a copy of the position paper on sample number twenty-six (26). This position paper was prepared by HQ AFMC/FMPC and coordinated with HQ AFMC/JAQ.

Once SAF/GC notifies us of the DoDIG's position related to Recommendation C.2., SAF/FMP will take action as required.

If you have any questions or concern, please contact Karen M. Thomas at 703.697.6052 or [karen.thomas@pentagon.af.mil](mailto:karen.thomas@pentagon.af.mil).

  
RICHARD P. GUSTAFSON  
Deputy Assistant Secretary  
Financial Operations  
(Financial Management)

Attachment  
AFMC Position Paper  
cc:  
SAF/FMPP  
SAF/GC

Attachments  
Not Included



DEPARTMENT OF THE AIR FORCE  
WASHINGTON DC

23 JAN 2008

Office Of The Assistant Secretary

MEMORANDUM FOR THE ASSISTANT INSPECTOR GENERAL FOR AUDITING  
OFFICE OF THE INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE

FROM: SAF/FMP  
1130 Air Force Pentagon  
Washington, DC 20330-1130

SUBJECT: Response to Audit Report D2004-D00FD-0040.004, Sample 27

This memo is in response to audit report D2004-D00FD-0040.004, sample number 27 contract number F625262-03-C00049. This contract was selected for a DoDIG review of the Vendor Pay Disbursement Cycle, Air Force General Fund. The DoDIG contends that said contract was not a bona fide need in fiscal year 2003. Based on the 5AF/JA Legal Review memorandum dated 22 November 2005 (Atch 1) the Air Force had a bona fide need to replace Building 345 HVAC system at Yokota AB on 19 September 2003, when the contract was awarded and the AF incurred the obligation. The work order shows the start date of 10 October 2003, 21 days after the contract award, therefore no violation of the bona fide need rule occurred.

Your request for a copy of invoice (Atch 2) is attached and has been translated to English by Ms. Yoshi Okumura, a 374<sup>th</sup> Contract Administrator and reviewed by the Contracting Officer, Ms. Eriko Fukushima. The bottom line is that the material submittals and the invoice are sufficient to show work was commenced before 1 January 2004.

Supporting documents are attached to provide you sufficient information that the bona fide need rule was not violated. The supporting documentation includes legal review by the 5 AF/JA, e-mails from SAF General Counsel agreeing with the JA's review, invoice, contract, and Contract Progress Schedule. We believe that you will find sufficient legal cites (FAR and FMR) in the attached documents.

If you have any questions or concerns, please contact, Ms. Karen M. Thomas at 703.697.6052 or karen.thomas@pentagon.af.mil

RICHARD P. GUSTAFSON  
Deputy Assistant Secretary  
Financial Operations  
(Financial Management)

Attachments  
Not Included

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Final Report  
Reference

Attachments  
Not Included

Attachments:  
5 AF/JA Memorandum  
Contract Invoices  
SAF/FMP Memorandum,  
SAF/GC E-mail  
Copy of Contract

cc:  
SAF/FMPP

# Defense Finance and Accounting Service Comments



**DEFENSE FINANCE AND ACCOUNTING SERVICE**  
8899 EAST 56 TH STREET  
INDIANAPOLIS, INDIANA 46249

OCT 16 2007


DFAS-JJR/IN

MEMORANDUM FOR DIRECTOR, AUDIT FOLLOW-UP AND GAO AFFAIRS,  
OFFICE OF THE INSPECTOR GENERAL,  
DEPARTMENT OF DEFENSE

SUBJECT: DFAS Response to the DoD IG Audit Report "Vendor Pay Disbursement  
Cycle, Air Force General Fund," Project No. D2004-D000FD-0040.004,  
dated September 5, 2007

Attached are the management comments to Recommendations A3, B1, B2a, B2b  
of the subject report.

Questions your staff may have concerning matters for recommendation A3 may be  
directed to Mr. Tony Bedwell at (317) 510-3899. Questions pertaining to  
recommendations B1 and B2a may be directed to Mr. Juan Camacho at (317) 510-3463.  
Questions pertaining to recommendation B2b may be directed to Ms. Rebecca Beck  
(614) 693-7613.

  
William E. Bergmeyer  
Director, Corporate Reporting  
Standards & Compliance

Attachment:  
As stated

[www.dfas.mil](http://www.dfas.mil)  
Your Financial Partner @ Work

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**Management Comments on DoDIG Draft Audit Report,  
"Vendor Pay Disbursement Cycle, Air Force General Fund,"  
Project Number D2004-D000FD-0040.004,  
dated September 5, 2007**

**Recommendation A.3.:** We recommend that the Director, Defense Finance and Accounting Service coordinate with the Office of the Under Secretary of Defense (Comptroller) to revise the accounting policies for foreign currency gains and losses.

**Current Management Comments:** Non-concur. Stakeholder: Policy & Requirements, Mr. Tony Bedwell at (317) 510-3899. DoDIG recommended that DFAS process foreign currency gains and losses on the date of the payable in accordance with Generally Accepted Accounting Principles (GAAP). There is currently no Federal Accounting Standards Advisory Board guidance that addresses the foreign currency recommendation outlined in this report. Instead, IG has interpreted Statements of Financial Accounting Standards (SFAS) 52, "Foreign Currency Translations," as being applicable to recognition of foreign currency fluctuation gains/losses. This interpretation is problematic since SFAS 52 pertains to the translation of foreign subsidiary financial statements into U.S. dollar equivalents. The DoD does not prepare financial statements in host country currencies that would require such translations to U.S. dollar equivalents. Additionally, SFAS 52 defines transaction gains or losses reflected in such restatements as the difference between exchange rates as of the "transaction date" and the "translation" reporting date. The IG recommends recognizing a gain/loss as of the date the payable is recognized. DoD's transaction date for recognition of the accounts payable is the date of receipt of goods/services. Consequently, there is no gain/loss to recognize on the date the payable is recognized in accordance with GAAP (SFAS 52).

**Estimated Completion Date:** This recommendation is considered closed.

**Recommendation B.1.:** We recommend that the Director, Defense Finance and Accounting Service request the Office of the Secretary of Defense, Office of General Counsel for a definitive legal opinion related to the legal or administrative authority for Defense Financial Accounting Service to make interest entitlement decisions based on the predominant contract line item.

**Current Management Comments:** Partially Concur. Stakeholder: Standards & Compliance, Accounts Payable, Mr. Juan Camacho at (317) 510-3463. DFAS Standards and Compliance will request a legal opinion from DFAS Office of General Counsel.

**Estimated Completion Date:** January 1, 2008

**Recommendation B.2a:** We recommend that the Director, Defense Finance and Accounting Service revise Defense Finance and Accounting Service policies, procedures, and guidelines based on the definitive opinion of the Office of the Secretary of Defense, Office of General Counsel, provided in response to Recommendation B.1.

**Current Management Comments:** Concur. Stakeholder: Standards & Compliance, Accounts Payable, Mr. Juan Camacho at (317) 510-3463. DFAS Standards and Compliance will revise procedural guidance if necessary based on the outcome of recommendation B1.

**Estimated Completion Date:** To Be Determined

**Recommendation B.2.b:** We recommend that the Director, Defense Finance and Accounting Service establish procedures and automated system controls to segregate the material and labor portions of time-and-materials and labor-hour contract interim payments to prevent the payment of interest on the material portion.

**Current Management Comments:** Non-concur. Stakeholder: Rebecca Beck at (614) 693-7613. Per Public Law (PL) 106-398, 114 Stat. 1654, states that "...the head of an agency acquiring services from a business concern under a cost reimbursement contract requiring interim payments who does not pay a required interim payment by ...[the due date] shall pay an interest penalty to the concern on the amount of the payment due." 5 Code of Federal Regulations (CFR) 1315.2(h) states: "For purposes of this part, interim payments under a cost-reimbursement service contract are treated as invoice payments..." 5 CFR 1315.10(b)(1) states: "Interest may be paid...when the payment is an interim payment under a cost-reimbursement service contract." 5 CFR 1315.20 states that the law "requires an agency to pay an interest penalty whenever the agency makes an interim payment under a cost reimbursement contract for services..." 5 CFR 1315.20(a) states that the law "applies to interim payment requests...under cost reimbursement service contracts." Federal Acquisition Regulation (FAR) 52.232-7 establishes that although time-and-material (T&M) and labor-hour (LH) contracts are for some purposes distinguishable, for purposes of Prompt Payment Act (PPA) interest they are treated the same.

There is no authority for DFAS to engage in a payment-by-payment analysis and pay or not pay interest based upon the characteristics of the specific item. If a late interim payment is made under a cost-reimbursement service contract, interest is owed. The nature of the specific payment as either a payment for a service or a payment for a good is irrelevant to this analysis. This analysis is explicitly carried over to T&M/LH contracts in the clause at FAR 52.232-7(h). It states: "Interim payments on contracts for other than services. (1) Interim payments made prior to the final payment under the contract are contract financing payments. Contract financing payments are not subject to the

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interest penalty provisions of the Prompt Payment Act.” It further states “Interim payments on contracts for services. For interim payments made prior to the final payment under this contract, the Government will make payment in accordance with the Prompt Payment Act...”

Neither the FAR nor the Office of Management and Budget (OMB) regulations prescribe a payment-by-payment analysis of the item being delivered. The analysis of whether a contract is a “contract for services” is made at the contract level. DFAS determines (with reference to whether the contracting officer has identified the contract as a “Kind 6” – service contract) whether the subject contract is a service contract.

**Estimated Completion Date:** This recommendation is considered closed.

**With the recent Base Realignment and Closure transition, this audit was transferred to DFAS Columbus from DFAS Denver. Upon receiving and reviewing this audit, DFAS Columbus is providing the current management comments below in response to the DoDIG comments included in the narrative of the draft audit report addressing the prior management comments provided by DFAS Denver.**

We recommend that the Assistant Secretary of the Air Force (Financial Management and Comptroller) and the Director, Defense Finance and Accounting Service, coordinate and direct the:

**Recommendation 1:** System changes and integration of the General Accounting and Finance System-Base Level, Integrated Accounts Payable System, and Mechanization of Contract Administration Services system so that the General Accounting and Finance System-Rehost recognizes transactions as of the date the financial events transpired, and all source document references are provided and transactions can be readily traced to the supporting documents.

**Prior Management Comments:** The audit response indicated that our original response was “not responsive”. Our position remains the same as a “Partially Concur” and is broken down below into two separate responses that address the two different recommendations presented in this audit recommendation and the unique process surrounding the IAPS and MOCAS processing into GAFS-BL:

- (1) Partially Concur to system changes and integration of IAPS, MOCAS, GAFS-BL and GAFS-R Datamart to ensure the system IAPS and MOCAS are entitlement systems that are considered subsidiary ledgers to our AF accounting systems, GAFS (includes GAFS-BL and GAFS-R Datamart). Records of the financial events addressed in this audit are contained in these systems, to include obligation



date, receipt date, invoice date, disbursement date, etc. This information is used in the entitlement process and maintained in those systems. The accounting system is intended to record the date the financial event was recognized and the entitlement systems maintain the date the event occurred.

- a. IAPS and GAFS-BL are integrated through the interactive communication interface (ICI) which is a real-time interface. Therefore, as soon as a financial event is recognized that triggers an accounting update, a transaction is posted to the accounting system in a very timely manner. The actual dates of the financial events mentioned in this audit are maintained in IAPS, a subsidiary ledger to GAFS-BL, and can be readily obtained. The fact that the financial event is not reported on the date it occurred is not a problem inherent to the system, but instead is attributable to procedural and routing issues, to include requirements that specify contractor coordination on invoices and/or receipts. It was noted by the auditors that disbursements are not posted on the date of the disbursement. For IAPS, this is an incorrect statement. The acknowledgment from the disbursing system that a payment will be posted is entered into the accounting system, GAFS-BL, on the same date that the disbursement has been made. The Merged Accountability and Funding Report (MAFR) process at Field Sites ensures these two events occur at the same date. The DEAMS efforts will further integrate the IAPS and GAFS-BL processes as they replace these systems in 2010/2011 timeframe.
- b. MOCAS is an entitlement system that is not integrated with GAFS-BL, but still serves the same purpose as a subsidiary ledger to GAFS-BL. The delay in posting events recorded in MOCAS into the GAFS-BL system is a condition that is prevalent throughout the Department of Defense. Until DoD has DoD-wide integrated system, there will always be timing delays for posting accounting transactions made by other DoD paying and disbursing stations (aka: Transactions For Others, Transactions By Others). Disbursements are posted to GAFS-BL based upon MOCAS notification through the CPN (Contract Payment Notice) interface to the GAFS-BL, which is processed as a Transactions By Others (via DCMS-DFB) to accounting system. This interface process introduces a delay in posting disbursements. For recognition of the Accounts Payable, our GAFS-BL system is updated through notification of a pending invoice, via the Prevalidation Process (UPVM), and is not made based upon posting of a receipt. Because of this, a more significant delay may be realized if the invoice is received much later than the receipt record. As stated in our original response, we would like to evaluate the potential for daily interfaces of receipt transactions from MOCAS to ensure more timely posting to the General Ledger for the majority of the MOCAS generated Accounts Payable records.

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- c. Additionally, there is an effort within DFAS called BAM, Business Activity Monitoring, for which the MOCAS and GAFS-BL data will be compared to ensure timely posting of actions in MOCAS that should be reflected in the accounting system. This process can possibly be expanded to ensure more timely recognition of Accounts Payable.
- (2) Non-concur to system changes and integration of IAPS, MOCAS, GAFS-BL, and GAFS-R Datamart. Records of the financial events addressed in this audit are contained in these systems, to include reference numbers for obligations, receipts, invoices and disbursements. This information is used in the entitlement process and maintained in those systems. The accounting system maintains sufficient information to trace back to the entitlements system to obtain such references. For example, you will never find an invoice number in the General Ledger or Accounting system. Instead, you will be able to find a disbursement against a specific obligation number, which, when tracked back to the entitlement system, will have a reference to the invoice. Therefore, through referential integrity, the source document references can be obtained within IAPS and MOCAS as subsidiaries to the GAFS-BL.

**Prior Estimated Completion Date:** Estimated completion date for evaluating MOCAS interface of receiving report information is July 1, 2007. Implementation dates will be established once the scope and magnitude of the changes have been determined.

**Prior Point of Contact:** Deborah Los, DFAS-JXD/DE, commercial: (303) 676-8192, DSN: 926-8192.

**Current Management Comments:** DFAS Columbus agrees with DFAS Denver on partially concurring with the recommendation that there is no need to implement system changes and integrate Mechanization of Contract Administration Services (MOCAS), Integrated Accounts Payable System (IAPS), General Accounting and Finance System – Business Line (GAFS-BL) and General Accounting and Finance System – Rehost Datamart (GAFS-R Datamart) in order for them to recognize transactions as of the date the financial events transpired.

DFAS Columbus determined that, at this time, there are no processes relating to this recommendation that need to be fixed. The audit was completed prior to the implementation of a new accrual process that is documented in the MOCAS Accounts Payable Accrual procedure; which was first used during September 2007 month-end reporting.

For MOCAS payments, the receipts are currently being recorded in the accounting system using the prevalidation approval date as opposed to the actual receipt date. DFAS Columbus has developed a process for estimating and recording the MOCAS Accounts Payable accruals at the end of each reporting period. This process reports accounts

payable activity for which a prevalidation notification has not been sent or confirmed prior to the end of the reporting period. Various MOCAS files are used to calculate accruals to summarize unpaid contract liabilities for accepted deliveries and performance, as well as any related holdbacks by individual funds and appropriation. In addition, the prevalidated amounts associated with all MOCAS payment types are identified on the monthly MOCAS reports so that the appropriate adjustments are made to avoid duplication. The MOCAS accrual process presents an accurate portrayal in the financial statements of the accounts payable balances. These accruals account for the "financial events" that must be recorded at the end of the month.

The Integrated Accounts Payable System (IAPS) differs from MOCAS in that IAPS is integrated with GAFS-BL through the interactive communication interface (ICI) and a payment is posted in the accounting system the same day the payment was made. The Merged Accountability and Funding Report (MAFR) report verifies these dates and thus shows GAFS-BL is in fact integrated with IAPS and recognizes transactions as of the date the financial events transpired.

DFAS Columbus also agrees with DFAS Denver in its non-concurrence because all source document references are provided and transactions can be readily traced to the supporting documents in the accounting and entitlement systems. The trial balance amounts can be traced back to the subsidiary ledger process using the accounting system (GAFS-BL, GAFS-R Datamart) information to trace back to the entitlements system (IAPS, MOCAS) to obtain such references. DFAS Columbus agrees that there is referential integrity between the accounting and entitlement systems and that the source document references are resident and accessible in IAPS and MOCAS; thus providing a necessary audit trail.

**Current Estimated Completion Date:** This recommendation is considered closed.

**Recommendation 2:** System Changes and integration of the Integrated Accounts Payable System, General Accounting and Finance System-Base Level, and General Accounting and Finance System-Rehost to process foreign currency fluctuation gains and losses in accordance with generally accepted accounting principles.

**Prior Management Comments:** Non-concur. We have no authority to deviate from the requirements of the DoD FMR. Please refer to prior management comments below:

"Non-concur. Foreign currency fluctuation gains and losses are processed today in accordance with the DoD FMR. If the DoDIG believes the DoD FMR is not in compliance with the generally accepted accounting principles, suggest the intent of this recommendation be re-directed to the OSD Comptroller. The DoD FMR would need to be changed (and systems as well) in order to recognize gains and losses when Accounts

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Payable (A/P) are recorded rather than at the time of disbursement. It should be noted there is no gain or loss to recognize prior to the payment (settlement) of the vendor. The gain or loss to the Government is recognized on a cash basis when the funds are actually disbursed or collected, i.e., actual cash inflow or outflow. It is the difference between the obligation amount, which is calculated based on the budget rate for appropriations eligible to participate in the foreign currency fluctuation (FCF) program, and the daily currency exchange rate in effect on the date of payment or collection (see DoD FMR, Vol. 3, Chapter 8, and Vol. 6, Chapter 7 for additional guidance). OSD publishes budget execution rates at the beginning of each FY for the currencies covered under the FCF program. Foreign currency fluctuation procedures do not apply when the performing activity is funded by the Defense Working Capital Fund.”

**Prior Estimated Completion Date:** This recommendation is considered closed.

**Prior Point of Contact:** N/A

**Current Management Comments:** DFAS Columbus agrees with DFAS Denver on non-concurring with this recommendation. The situation that the DoDIG addresses occurs when a contract is issued and payment is expressed in foreign currency. At the time of award, the amount of the foreign currency is converted into a U.S. dollar equivalent under DoD FMR Volume 6, Chapter 7, Paragraph 070106-B. The U.S. dollar amount is recorded as an obligation in the accounting records. When delivery under the contract is received, the amount previously obligated is recorded as a liability and expense. At the time of delivery, no gain or loss is due to currency fluctuations since the date of contract issuance is recorded as a liability and expense. At the time of payment, the gain or loss is recognized. Volume I Treasury Financial Manual Section 9045.10 states that agencies should not hold currency balances in excess of their immediate needs and that all foreign currency exchanges are to be conducted for “spot” delivery. DFAS can not purchase and hold foreign currency for future use, and it can not enter into future or options contracts to mitigate the effects of future currency fluctuations.

The DoDIG states that under GAAP, a liability/expense for the gains and an asset/revenue for the losses on currency exchanges should be accrued when the items are delivered and when the liability for the delivered item is recognized. Under Statement of Financial Accounting Concept No. 5, an item should be recognized if: (1) It meets the definition of an element of financial statements; (2) It is measurable with sufficient reliability; (3) It is relevant; and (4) It is representational faithful, verifiable, and neutral. All four criteria are subject to pervasive cost-benefit constraint: the expected benefits from recognizing a particular item should justify perceived costs of providing and using the information.

The gain or loss on currency exchanges arguably fails both the measurement requirement and the cost-benefit constraint. It fails the measurement requirement because the amount

of the currency gain or loss can not be determined at the time of delivery. It can only be determined at the time of disbursement. It fails the cost-benefit constraint because the period between delivery and disbursement is usually relatively short. DoD FMR Volume 6, Chapter 7, Paragraph 070106-2 states: "adjustments to reflect fluctuations in such rates should be recorded as disbursements are made." The DoDIG's proposal would require DFAS to accrue a gain or loss that is estimated, and then adjust that gain or loss again (ordinarily within a matter of days) based on the currencies' continuing fluctuations.

**Current Estimated Completion Date:** This recommendation is considered closed.

**Recommendation 3:** System changes to create an edit in the General Accounting and Finance System-Base Level to account for a delivered order, unpaid and account payable prior to or concurrent with a disbursement. The goods or services receipt date (financial event) must be shown as the effective date of the delivered order, unpaid and account payable entry so the transaction can be properly recognized as a prior period event requiring a prior period adjustment to the financial statements or a current period event.

**Prior Management Comments:** Non-concur. Additional comments are as follows.

The "matching" concept discussed in this finding to ensure an Accounts Payable exists prior to or concurrent with the related disbursement is a control that already exists in the entitlement systems, IAPS and MOCAS. For IAPS, this process is internal to IAPS and because of its integration with GAFS-BL, is carried through to the accounting system. For the MOCAS disbursements, the MOCAS prevalidation process ensures the "delivered order –unpaid" and account payable are posted in the accounting system prior to the receipt of the disbursement transaction, which is received via the CPN/TBO process discussed in management comments to Recommendation 1.

In regard to the recommendation to change GAFS-R Datamart to recognize the actual financial event date as the "effective date" and posting as a prior period adjustment, where warranted, to include reinstatement of financial statements. The audit report states the impact of this issue to be potential under or overstated values for proprietary and budgetary accounts used to generate the Report on Budgetary Execution (SF-133), Statement of Budgetary Resources, and other financial statements. However these financial statements are generated and reviewed monthly and quarterly, and discrepancies between event date and accounting post date that are within the accounting period are resolved before the end of the period reports are generated.

Additionally, at the end of each reporting period, we have developed a process for anticipating and recording the IAPS and MOCAS Accounts Payable accruals. For IAPS, this process uses an estimating technique to compensate for the known delays outside of the entitlement and accounting systems that result in delayed reporting of receipt activity.

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For MOCAS, this process reports accounts payable activity for which a prevalidation notification has not been sent or confirmed prior to the end of the reporting period. Both of these accrual processes are accomplished at a summary level but attempt to present a more accurate portrayal in the Financial Statements of the Accounts Payable balances.

For those instances where the transaction date would have been posted to a prior period, reinstatement of prior period financial statements may end up disguising the impact of that delayed recognition of the financial event since Financial Managers are more likely to be reviewing the most current financial statements and not prior reinstated financial statements. Therefore, we believe that the posting of these transactions in current period is the better approach to ensuring management has the most accurate information available to them in their financial statements.

While we agree that improvements need to be made to the process to ensure financial events are recognized and recorded in as timely a manner as possible, the majority of the significant discrepancies between the date of the financial event and the date of the recording of the financial event are typically due to reasons that cannot be attributable to the accounting system. Examples include: failure to generate receiving reports timely, sending invoices and or receiving reports to the wrong office, necessity to obtain contracting officer approval of receiving reports/invoices, etc. While these are all processes that can be facilitated by the government electronic solutions (i.e. Wide Area Work Flow), they are not conditions that can be corrected in the accounting or entitlement systems. Lacking these improvements, our best effort is made to post estimated accruals for Accounts payables that are anticipated to be recognizable in the current period. Reference response in recommendation 1 for potential to improve timing and completeness for recognizing MOCAS accounts payable activity.

**Prior Estimated Completion Date:** This recommendation is considered closed.

**Prior Point of Contact:** N/A

**Current Management Comments:** DFAS Columbus agrees with DFAS Denver on non-concurring with this recommendation. DFAS Columbus determined that, at this time, there are no processes relating to this recommendation that need to be fixed. The audit was completed prior to the implementation of a new accrual process that is documented in the MOCAS Accounts Payable Accrual procedure; which was first used during September 2007 month-end reporting.

The auditors had concerns relating to the delayed recognition of the actual financial event date for the Air Force accounts payable. Their recommendation stated that "the goods or services receipt date (financial event) must be shown as the effective date of the delivered order, unpaid and account payable entry so the transaction can be properly recognized as

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a prior period event requiring a prior period adjustment to the financial statements or a current period event."

For MOCAS payments, the receipts are currently being recorded in the accounting system using the prevalidation approval date as opposed to the actual receipt date. DFAS Columbus has developed a process for estimating and recording the MOCAS Accounts Payable accruals at the end of each reporting period. This process reports accounts payable activity for which a prevalidation notification has not been sent or confirmed prior to the end of the reporting period. Various MOCAS files are used to calculate accruals to summarize unpaid contract liabilities for accepted deliveries and performance, as well as any related holdbacks by individual funds and appropriation. In addition, the prevalidated amounts associated with all MOCAS payment types are identified on the monthly MOCAS reports so that the appropriate adjustments are made to avoid duplication. The MOCAS accrual process presents an accurate portrayal in the financial statements of the accounts payable balances. These accruals account for the "financial events" that must be recorded at the end of the month. Because of these accruals, the financial statements are not materially misstated, and would not require a prior period adjustment. These accruals address the intent of the auditor's recommendation "to change GAFS-R Datamart to recognize the actual financial event date as the effective date and posting as a prior period adjustment, where warranted, to include reinstatement of financial statements", by ensuring payables are reflected in the appropriate period.

The auditors also stated "We believe DFAS must have the capability to assess potentially material prior period adjustments created on a transaction or accrual basis and restate prior period financial statements in accordance with SFFAS No. 21." DFAS Columbus concurs that a prior period adjustment needs to be made when an error would materially misstate the prior period or the current period financial statements and it would be probable that the judgment of a reasonable person relying on the information would be changed or influenced by the inclusion of the item as in accordance with SFFAS No. 21. The prior period adjustment accounts would not be used when an error or misstatement is discovered that does not materially misstate the financial statements. In such cases, post a correcting adjustment as a current year transaction to current year accounts. The SFFAS No. 21 instructs that prior period adjustments without restatement will be used for changes in accounting principles unless otherwise directed by a new accounting standard.

**Current Estimated Completion Date:** This recommendation is considered closed.

**Recommendation 4:** System changes, personnel training, and processing procedures in the Mechanization of Contract Administration Services system to ensure processing of contract holdbacks and unfunded liabilities for integration with the General Accounting and Finance System—Base Level and Rehost systems. This includes recording an account

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payable when DFAS personnel reject an invoice because an obligation does not exist or the unliquidated balance is not sufficient to pay the vendor.

**Prior Management Comments:** Partially Concur. As stated in previous comments above, our position remains the same for unfunded liabilities. However, after further review, we agree that sample 36 is a contract holdback. DFAS San Bernardino paid the net amount of the invoice, withholding the contract holdback, but, may have processed the contract holdback incorrectly. In accordance with the Federal Financial Manager's Integrity Act (FMFIA) a review of MOCAS and IAPS contract holdback process will be conducted to determine the degree of risk and identify any deficiencies in the area. The estimated completion date is August 2, 2007, to ensure controls are in place and complete the review for contract holdbacks.

**Prior Estimated Completion Date:** August 2, 2007.

**Prior Point of Contact:** Gary Bethea, DFAS-JBI/CO, commercial: (614) 693-0840.  
DSN: 699-0840

**Current Management Comments:** DFAS Columbus continues to partially concur with the DoDIG statement that "We reported unfunded liabilities resulting from instances of vendor performance prior to the execution date of the delivery orders which provided funding. However, unfunded liabilities can also arise after the contract is input and later subject to the incremental funding clause under Federal Acquisition Regulation (FAR) 52.232-22. Under FAR 52.232-22, paragraph (i), a vendor can continue to perform and incur costs, which creates an unfunded liability. When additional funds are obligated on contract, the costs incurred are paid as if they were incurred when the funds were already obligated on the contract."

FAR 52.232-22(f) states that the government is not obligated to pay the contractor for costs in excess in the amount allotted to the contract and that the contractor is not obligated to perform after the amount allotted to the contract is exhausted. FAR 52.232-22(i) states that when and to the extent that the amount allotted to the contract is increased, any costs the contractor incurs prior to the increase are allowable. Many of the sections in FAR 52.232-22 clarify that unless and until the contracting office takes overt action to increase the amount allotted to the contract, the contractor is not entitled to be paid for its costs incurred over the allotted amount.

The government is not legally obligated to make payment for incurred costs in excess of the amount allotted to the contract. It would be improper for DFAS to accrue a liability at the time the costs are incurred by the contractor, but prior to the DoD incurring a legal liability to pay them.



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In reference to the recommendation, "The director's final comments did not rescind the prior statement that contract holdbacks are recognized as accounts payables, instead of as other liabilities." DoD FMR Volume 4, Chapter 9, Paragraph 090101-C states: "Accounts payable also does not include amounts for contract holdbacks. Contract holdbacks map to the other liabilities line of the balance sheet." The treatment of contract financing payments has been a source of contention between the DoDIG and the DoD Comptroller for many years. The attached letter and attachments from the DoDIG to the FASAB dated October 28, 2005, reflects that continuing dispute. Given the continuing dispute regarding these issues at a high level, DFAS does not think we are in a position to substantively resolve these issues.

**Current Estimated Completion Date:** This recommendation is considered closed.



**DEFENSE FINANCE AND ACCOUNTING SERVICE  
ARLINGTON  
1851 SOUTH BELL STREET  
ARLINGTON, VA 22240-5291**

DEC 21 2007

DFAS-JJ/AR

MEMORANDUM FOR DIRECTOR, AUDIT FOLLOW-UP AND GAO AFFAIRS,  
OFFICE OF THE INSPECTOR GENERAL,  
DEPARTMENT OF DEFENSE

SUBJECT: DFAS Response to the DoD IG Audit Report "Vendor Pay Disbursement  
Cycle, Air Force General Fund," Project No. D2004-D000FD-0040.004,  
dated September 5, 2007

Attached are the management comments to Recommendation B1 of the subject  
report.

Questions your staff may have concerning matters for the recommendation may be  
directed to Mr. Juan Camacho (317) 510-3463.

David E. McDermott  
Deputy Director, Compliance  
Standards & Compliance

Attachment:  
As stated

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**Management Comments on DoDIG Draft Audit Report,  
“Vendor Pay Disbursement Cycle, Air Force General Fund,”  
Project Number D2004-D000FD-0040.004,  
dated September 5, 2007**

**Recommendation B.1.:** We recommend that the Director, Defense Finance and Accounting Service request the Office of the Secretary of Defense, Office of General Counsel for a definitive legal opinion related to the legal or administrative authority for Defense Financial Accounting Service to make interest entitlement decisions based on the predominant contract line item.

**Previous Management Comments:** Partially Concur. Stakeholder: Standards & Compliance, Accounts Payable, Mr. Juan Camacho at (317) 510-3463. DFAS Standards and Compliance will request a legal opinion from DFAS Office of General Counsel.

**Previous Estimated Completion Date:** January 1, 2008

**Current Management Comments:** Legal opinion requested from DFAS Office of General Counsel on October 31, 2007. Opinion received on December 20, 2007.

Development of policies, procedures and guidelines based upon the legal opinion provided will be addressed in the DFAS response to recommendation B2a.

**Completion Date:** This recommendation is considered Closed.



**DEFENSE FINANCE AND ACCOUNTING SERVICE**

P. O. BOX 182317  
Columbus, OH 43218-2317

DFAS-DGC

December 20, 2007

MEMORANDUM FOR DFAS, PATRICIA ROGERS

SUBJECT: Prompt Payment Act – Interim Payments

We have been requested by your office to provide legal comments on Recommendation B.1. “We recommend that the Director, Defense Finance and Accounting Service, request the Office of the Secretary of Defense, Office of General Counsel for a definitive legal opinion related to the legal or administrative authority for Defense Finance and Accounting Service to make interest entitlement decisions based on the predominant contract line item.” DFAS management partially concurred with the recommendation and stated it would obtain a legal opinion from DFAS OGC.

P.L. 106-398, §1, 114 Stat. 1654, October 30, 2000; P.L. 107-107, Div. A Title X, Subtitle A, §1007, 115 Stat. 1204, December 28, 2001, as set forth in a note to 31 U.S.C. §3902 states:

Prompt payment requirement for interim payments. Under regulations prescribed under section (c), the head of an agency acquiring services from a business concern under a cost reimbursement contract requiring interim payments who does not pay the concern a required interim payment by the date that is 30 days after the date of the receipt of a proper invoice shall pay an interest penalty to the concern on the amount of the payment due . . .

5 C.F.R. 1315.20 states:

Section 1010 of the National Defense Authorization Act for Fiscal Year 2001 (Public Law 106-398, 114 Stat. 1654, as amended by section 1007 of the National Defense Authorization Act for Fiscal Year 2002 (Public Law 107-107, 115 Stat. 1012), requires an agency to pay an interest penalty whenever the agency makes an interim payment under a cost-reimbursement contract for services more than 30 days after the date the agency receives a proper invoice for payment from the contractor. This part implements Section 1010, as amended, and is applicable in the following manner:

(a) This part shall apply to all interim payment requests that are due on or after December 15, 2000 under cost-reimbursement contracts awarded before, on, or after December 15, 2000.

(b) No interest penalty shall accrue under this part for any delay in payment that occurred prior to December 15, 2000.

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(c) Agencies are authorized to issue modifications to contracts, as necessary, to conform them to the provisions in this part implementing Section 1010, as amended.

In the process of the promulgation by OMB of this regulation, it stated at 65 F.R. 78403, 78404, December 15, 2000:

Newly added Section 1315.20 of the PPA regulation makes clear that the requirements of Section 1010 are to be implemented on an accelerated basis. Section 1315.20 requires agencies to immediately apply the revisions made by the interim rule to all interim payment requests under cost-reimbursement service contracts awarded on or after December 15, 2000.

The OMB regulations at 5 C.F.R. 1315.2(h) state: "Contract financing payments do not include . . . interim payments under cost-reimbursement service contracts." The clause at FAR 52.216-7(a)(2) states: "Contract financing payments are not subject to the interest penalty provisions of the Prompt Payment Act. Interim payments made prior to the final payment under the contract are contract financing payments, except interim payments if this contract contains Alternative I to the clause at 52.232-25."

The Prompt Payment Act at 31 U.S.C. 3902(c)(1) states that the penalty under the Prompt Payment Act should be paid without regard to whether the business has requested payment of such penalty. The penalty is not a payment under the contract, it is a statutory entitlement. DoDFMR Volume 10, Chapter 7, Paragraph 070301 states: "Whenever an interest penalty is due, the disbursing office will pay the interest due without requiring that the business concern request such interest." The disbursing office, if it determines that the payment is an interim payment on a cost reimbursement contract for services, must make the interest payment, notwithstanding the absence of Alternate I to the clause at FAR 52.232-25. The ultimate issue is whether the contract is in fact a "cost reimbursement contract for services".

The "predominant line item" test is not prescribed by any existing regulation or policy. No existing policy provides a "bright line test" for when a contract is in fact a "contract for services". The issue of whether most of the effort on a contract is for services would logically be a very important consideration that the paying office would use in determining whether a contract is a "contract for services" and whether interest were payable.

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Please address any questions to the undersigned.

A handwritten signature in black ink, appearing to read 'Mark B. Barta', with a long horizontal flourish extending to the right.

Mark B. Barta  
Deputy Assistant General Counsel  
Accounting and Commercial Law

## **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

