

Audit



Report

COMPILATION OF THE FY 1997 FINANCIAL STATEMENTS
FOR OTHER DEFENSE ORGANIZATIONS

Report No. 99-014

October 15, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CFO	Chief Financial Officers
DFAS	Defense Finance and Accounting Service
GLAC	General Ledger Account Code
IG	Inspector General
OMB	Office of Management and Budget



INSPECTOR GENERAL
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October 15, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on the Compilation of the FY 1997 Financial Statements for
Other Defense Organizations (Report No 99-014)

We are providing this report for review and comments. This audit was performed in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Because the Director, Defense Financial and Accounting Service did not comment on the draft report, we request that the Director provide comments on the final report by November 16, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Charles J. Richardson, at (703) 604-9582 (DSN 664-9582) (crichardson@dodig.osd.mil) or Mr. Marvin L. Peek, at (703) 604-9587 (DSN 664-9587) (mpeek@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in cursive script, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 99-014

October 15, 1998

(Project No 8FA-2010.01)

Compilation of the FY 1997 Financial Statements for Other Defense Organizations

Executive Summary

Introduction. This report is the second and final report on the compilation by the Defense Finance and Accounting Service (DFAS) Indianapolis Center of the FY 1997 Financial Statements for Other Defense Organizations. This report also summarizes conditions affecting the compilation process as reported in previous Inspector General, DoD, audit reports. We performed the audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires that DoD provide audited financial statements to the Office of Management and Budget.

The DoD Consolidating Financial Statements for FY 1997 included financial statements for a reporting entity called "Other Defense Organizations" that represents a consolidation of financial information from 44 Defense organizations, funds, and accounts using Treasury Index No. 97. The DFAS Indianapolis Center is responsible for preparing financial statements for Other Defense Organizations from information generated by multiple accounting systems and accounting offices. During FY 1997, the 44 Defense agencies, funds, and accounts included in Other Defense Organizations were appropriated \$39.1 billion, and their financial statements showed assets of \$46.5 billion, liabilities of \$222.2 billion, revenues and financing sources of \$50 billion, and expenses of \$49.7 billion.

Audit Objective. The overall audit objective was to determine whether the DFAS Indianapolis Center consistently and accurately compiled financial data from field accounting offices and other sources for the financial statements for Other Defense Organizations. Specifically, we evaluated whether the compilation of Other Defense Organizations financial information for the FY 1997 Financial Statements was complete, and whether the footnotes fully disclosed material discrepancies and additional information relevant to the statements. Our review of internal controls was reported in IG, DoD Report No. 98-178 "Internal Controls and Compliance with Laws and Regulations for the FY 1997 Financial Statements for Other Defense Organizations," July 13, 1998.

Audit Results. FY 1997 was the second year that DFAS Indianapolis Center prepared financial statements for Other Defense Organizations. Because of the lack of a complete standard general ledger control system, the DFAS Indianapolis Center could not accurately accumulate and report financial information. Therefore, the process used by DFAS Indianapolis Center to adjust, compile, and report financial information

for Other Defense Organizations needed improvements to ensure financial statements were complete, consistent, accurate, and fully supported. Specifically, the DFAS Indianapolis Center:

- made \$111.5 billion in year-end adjustments that were not adequately supported, and did not include \$68 million in accounts receivable from closed appropriations and a negative \$483 million in accounts payable (Finding A);
- reduced Fund Balance with Treasury for Entity Assets by \$5.3 billion without performing required reconciliations, and omitted a negative \$1 billion from Fund Balance with Treasury for Non-Entity assets as shown on the "Report(s) on Budget Execution" (Finding B); and
- did not prepare comprehensive Notes to the FY 1997 Financial Statements in compliance with guidance from DoD and the Office of Management and Budget (Finding C).

Unless the compilation process is improved, the financial statements for Other Defense Organizations will neither be complete nor reliable and will not meet the requirements of the Chief Financial Officers Act.

Summary of Recommendations. We recommend that the DFAS Indianapolis Center establish procedures for coordinating the adjustments to the trial balance with the affected Defense agencies, include accounts receivable and payable from closed appropriations in the Statement of Financial Position, maintain complete audit trails for the year-end adjustments, advise supporting accounting offices to stop using obsolete general ledger account codes, and establish procedures to ensure that discrepancies in Fund Balance with Treasury are researched and the causes documented. Also, we recommend that the DFAS Indianapolis Center comply with current form and content guidance from the Office of Management and Budget and DoD when preparing Notes to the financial statements, and disclose the reasons for significant variances in account balances for specific line items in the comparative financial statements.

Management Comments. The Director, Defense Finance and Accounting Service did not comment on the report. Therefore, we request that the Director provide comments on the final report by November 16, 1998.

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Part I - Audit Results

Audit Background

Requirement to Prepare Financial Statements. Public Law 101-576, the "Chief Financial Officers (the CFO Act) Act of 1990," November 15, 1990, requires Federal organizations to submit audited financial statements to the Director, Office of Management and Budget (OMB). Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires DoD and other Government agencies to prepare consolidated financial statements for FY 1996 and each succeeding year. In a memorandum dated June 6, 1995, the Deputy Chief Financial Officer, DoD, notified DoD Components of the FY 1996 requirement to prepare and submit financial statements in accordance with the Federal Financial Management Act of 1994.

FY 1997 Financial Statements for Other Defense Organizations. The DoD consolidated financial statements for FY 1997 include financial information for a reporting entity entitled "Other Defense Organizations." This entity includes appropriations, funds, and accounts using the Treasury Index No. 97 symbol (Department 97). The majority of Department 97 funds included in Other Defense Organizations are general funds appropriated for Defense agencies and organizations, including Defense-wide funds entrusted to the Military Departments. In FY 1997, the 44 Defense organizations, funds, and accounts included in Other Defense Organizations were appropriated \$39.1 billion to perform their missions and functions. The FY 1997 financial statements for Other Defense Organizations showed assets of \$46.5 billion, liabilities of \$222.2 billion, revenues and financing sources of \$50 billion, and expenses of \$49.7 billion.

Financial Statement Guidance. Guidance for the preparation and presentation of the financial statements required by the CFO Act is contained in the:

- American Institute of Certified Public Accountants Statement on Auditing Standards No. 32, "Adequacy of Disclosure in Financial Statements," October 1980;
- OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993 and OMB Bulletin No. 97-01, "Formats and Instructions for the Form and Content of Agency Financial Statements," October 16, 1996 (OMB Form and Content Guidance);
- DoD 7000.14-R "DoD Financial Management Regulation," volume 6, chapter 6, "Form and Content of Audited Financial Statements" (DoD Form and Content Guidance), January 1998¹; and

¹The Under Secretary of Defense (Comptroller) will issue new guidance of the form and content of financial statements for FY 1998 and subsequent years.

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- “Fiscal Year 1997 Year-End Instructions for Treasury Index 97 Financial Reporting to DFAS Indianapolis Center,” issued by the Defense Finance and Accounting Service (DFAS) Indianapolis Center, August 11, 1997.

Roles and Responsibilities. The roles and responsibilities of DFAS and its customers regarding proper and consistent preparation of the financial statements are defined in DoD Regulation 7000.14-R, volume 6, chapter 2, “Departmental Financial Reports Roles and Responsibilities,” February 1996. The regulation requires DFAS to establish procedures to ensure that the process for preparing financial statements is consistent, timely, and auditable, and that controls are in place to ensure the accuracy of the statements. The regulation also requires DoD Components to review all financial statements prepared by DFAS to assess the accuracy of the information being reported and ensure that the amounts in the financial statements are consistent and reconcilable with the data in management reports prepared by the DoD Component customers. Beginning in FY 1996, the DFAS Indianapolis Center became responsible for preparing the financial statements for Other Defense Organizations in accordance with the OMB and DoD Form and Content Guidance.

In compiling and preparing the financial statements for Other Defense Organizations, the DFAS Indianapolis Center:

- obtained fiscal year-end trial balances and other financial information from the supporting accounting offices,
- consolidated the financial information received, and
- made summary adjustments to change general ledger account balances to agree with the applicable balances shown on year-end certified “Report(s) on Budget Execution” and other information received from the Defense organizations.

Audit Objective

The primary audit objective was to determine whether the DFAS Indianapolis Center consistently and accurately compiled financial data received from field accounting offices and other sources for the financial statements for Other Defense Organizations. Specifically, we evaluated whether the compilation of Other Defense Organizations’ financial information for the FY 1997 financial statements was complete, and whether the footnotes to the financial statements fully disclosed material discrepancies and additional information relevant to the financial statements. Appendix A discusses the audit scope and methodology. Appendix B lists the prior audit coverage. Our review of internal controls is reported in IG, DoD, Report No. 98-178, “Internal Controls and Compliance with Laws and Regulations for the FY 1997 Financial Statements for Other Defense Organizations,” July 13, 1998.

Finding A. Compilation of Financial Statements

The process used by the DFAS Indianapolis Center to adjust, compile, and report financial information for Other Defense Organizations needed improvements. At least \$111.5 billion of the \$550.3 billion in year-end adjustments made by the DFAS Indianapolis Center were not adequately supported. Also, the balance reported for accounts payable and accounts receivable from closed appropriations was overstated by \$483 million and understated by \$68 million, respectively. The reliability and accuracy of the financial statements were questionable primarily because the DFAS Indianapolis Center and the supporting accounting offices did not have complete transaction-driven general ledger accounting control systems to accurately accumulate and report financial information. Also, the conditions occurred because the DFAS Indianapolis Center did not:

- support summary year-end adjustments it made to the trial balances for Other Defense Organizations adequately,
- implement corrective actions fully to correct problems identified by our prior audits,
- comply with DoD Form and Content Guidance, which requires that the balances from closed appropriations be accurately included in the financial statements, and
- obtain reliable and required financial information in a timely manner from the accounting offices supporting Other Defense Organizations.

As a result, the FY 1997 financial statements compiled for Other Defense Organizations by DFAS Indianapolis Center were subject to material misstatement and could not be relied on. Further improvements in the compilation process would increase the value and reliability of the financial statements for other Defense Organizations.

Compilation Process for Other Defense Organizations

In compiling the FY 1997 financial statements for Other Defense Organizations, the DFAS Indianapolis Center obtained individual trial balances from the supporting accounting offices, consolidated the financial information from the trial balances received and made 129 year-end adjustments totaling \$550.3 billion to the Other Defense Organizations trial balances. Those adjustments were prepared because the DFAS Indianapolis Center and the accounting offices that support the Other Defense Organizations did not have complete general ledger accounting control systems that could provide reliable information. Also, supporting accounting offices did not submit required monthly trial balances to DFAS Indianapolis Center, as requested.

Finding A. Compilation of Financial Statements

Complete Standard General Ledger Accounting Control Systems. DoD Regulation 7000.14-R, volume 1, "General Financial Management Information, Systems, and Requirements," May 1993, states that the DFAS shall maintain and operate a central double-entry general ledger. The central general ledger and its subsidiary ledgers, and reports should serve as the source data base for producing financial statements for Military Departments and Defense Agencies. However, prior audit reports show that DoD financial accounting systems are not fully compliant with regulatory and statutory requirements. For example, Inspector General (IG), DoD, Report No. 97-225, "Major Deficiencies Preventing Favorable Audit Opinions on the FY 1996 DoD General Fund Financial Statements," September 30, 1997, states that accounting systems supporting DoD General Funds did not have integrated, double-entry, transaction-driven general ledgers to compile and report reliable and auditable information. The information was not auditable because the accounting systems did not produce complete audit trails for accounting transactions to support balances reported on the required financial statements. The report also stated that DoD use of noncompliant accounting systems would continue to cause auditors to disclaim opinions on the DoD financial statements.

Monthly Trial Balance Submissions. IG, DoD, Report No. 99-006, "Consolidation Process for FY 1997 Financial Statements for Other Defense Organizations," October 6, 1998, states that the supporting accounting office did not always submit monthly trial balances to the DFAS Indianapolis Center as required. The purpose of monthly trial balance submissions is to update the departmental accounting records throughout the year and to determine the causes of differences between those records and trial balances. Had the supporting accounting offices complied with this requirement, many of the year-end adjustments to the consolidated trial balance for Other Defense Organizations may have been eliminated.

Adjustments Without Adequate Support

The DFAS Indianapolis Center did not have sufficient support for 56 of the 129 year-end adjustments made to the Other Defense Organizations trial balances. The 56 year-end adjustments totaled \$111.5 billion. The adjustments were not supported in accordance with Key Accounting Requirement No. 8,² "Audit Trails" and did not fully implement corrective actions to correct the problem identified by the IG, DoD, Report No. 97-151, "The Fund Balance With Treasury Account for the Research Development, Test and Evaluation Appropriation, Department 97," June 4, 1997. The 56 adjustments fall into three general categories:

Adjusting Trial Balances to Agree With "Report(s) on Budget Execution." Because of the lack of reliable and complete financial information, the DFAS

²DoD Regulation 7000.14-R, volume 1, identifies 13 key accounting requirements. Key accounting requirements are a composite of General Accounting Office, OMB, Department of Treasury, and DoD regulations. All DoD accounting systems must comply with key accounting requirements.

Finding A. Compilation of Financial Statements

Indianapolis Center could not use portions of the data submitted as the source for compiling the financial statements for the Other Defense Organizations. Instead, the DFAS Indianapolis Center adjusted the trial balance amounts for certain accounts to match the amounts reported in the budget execution reports. The DFAS Indianapolis Center made 19 adjustments totaling \$99.7 billion to force the Other Defense Organizations' trial balances to agree with the "Report(s) on Budget Execution" without a complete audit trail to supporting documentation. Key Accounting Requirement No. 8, "Audit Trails" states that the financial transactions on accounting system process must be adequately supported with pertinent source documentation. Also, the DFAS Indianapolis Center did not request supporting accounting offices to reconcile or explain the differences as required by DoD Regulation 7000.14-R, volume 6. The regulation requires the DFAS to adequately support and justify in writing any adjustments to the official accounting records, and to obtain customer approval before recording adjustments.

Eliminating Obsolete Accounts. The Under Secretary of Defense (Comptroller) removed the Cumulative Results of Operations - Other Appropriations [General Ledger Accounting Code (GLAC) 3318] and Net Results of Operations - Other Appropriations (GLAC 3328) from the DoD Uniform Chart of Accounts because entities that receive appropriated funds should not have gains or losses as a result of operations. However, the supporting accounting offices continued reporting balances for those GLACs to the DFAS Indianapolis Center. The DFAS Indianapolis Center did not ask the supporting accounting offices to explain these balances and assumed that the transactions were inadvertently posted to the wrong accounts. Accordingly, DFAS Indianapolis Center made 3 adjustments totaling \$7.1 billion to transfer these balances to Transfers-in from Others Without Reimbursement (GLAC 3220) and Transfers-out to Others Without Reimbursement (GLAC 3231) without verifying the appropriateness or accuracy of the adjustments.

Correcting Errors. The DFAS Indianapolis Center made 34 adjustments totaling \$4.7 billion to correct account balances in the consolidated trial balances. However, the DFAS Indianapolis Center did not have a complete audit trail to support the reasons for the adjustments. For example, the supporting documentation for one adjustment (JV1273419BDM) for \$1.3 billion was a spreadsheet generated by accounting personnel plus the excerpt from the consolidated trial balance. However, support for the adjustment did not include a reason for the adjustment, source documentation to support the adjusted amounts, or when and how the error was identified.

Implementation of Prior Audit Recommendation. IG, DoD, Report No. 97-151, "The Fund Balance with Treasury Account for the Research, Development, Test and Evaluation Appropriation, Department 97," June 4, 1997, recommended that the DFAS Indianapolis Center coordinate adjustments with the affected Defense organizations to determine the causes of the differences between certified "Report(s) on Budget Execution" and reported trial balances. In responding to the prior audit recommendation, the DFAS indicated that it would notify Defense agencies of adjustments on their individual reports by disclosing the adjustments and the methodology used. Also, the DFAS stated that the required adjustments would be reduced as the Defense agencies became more familiar with the reporting process and the

Finding A. Compilation of Financial Statements

requirements. However, our review of the adjustments made to several material lines in the financial statements showed that the agreed upon corrective actions were not adequately implemented. Also, the number of adjustments for the FY 1997 financial statements increased from 47 in FY 1996 to 129 in FY 1997 or from \$88.3 billion to \$550.3 billion.³

In responding to the report, DFAS stated that "once DoD accounting systems are implemented to update and produce general ledger trial balances, the Defense agencies will have individual visibility of their reports." The DFAS Indianapolis Center stated that the time constraints imposed by the CFO Act and the lack of complete and timely submission from supporting accounting offices prevented the DFAS Indianapolis Center from fully coordinating with Defense agencies to determine the accuracy and the completeness of the adjustments. Report No. 97-151 dealt only with adjustments to Fund Balance with Treasury. The recommendation to DFAS in the current audit includes all accounts. DFAS Indianapolis Center needs to establish procedures and processes to coordinate adjustments to trial balances submitted for Other Defense Organizations.

Reporting Accounts Payable and Accounts Receivable

The DFAS Indianapolis Center did not accurately report accounts payable and accounts receivable for closed (canceled)⁴ appropriations. This condition occurred because the DFAS Indianapolis Center did not fully comply with the revised DoD Form and Content Guidance, which requires that the balances from closed appropriations be accurately included in the financial statements.

Accounts Payable. DoD Form and Content Guidance requires that accounts payable established under accounts that are now canceled be included in the financial statements. The DFAS Indianapolis Center reported \$607 million in accounts payable in the Statement of Financial Position. However, "Report(s) on Budget Execution" showed liabilities of only \$125 million. Accordingly, accounts payable was overstated by about \$483 million because the Report(s) on Budget Execution included negative liabilities from closed appropriations not included in the Statement of Financial Position. The DFAS Indianapolis Center accounting personnel stated they did not have sufficient time to include accounts payable from closed appropriations because the revised guidance from DoD was not finalized until January 1998, after DFAS had already prepared "version 1" of the financial statements.

Accounts Receivable. DoD Form and Content Guidance requires that accounts receivable established under accounts that are now canceled be included in the financial statements. However, DFAS Indianapolis Center did not include \$68 million in accounts receivable from closed appropriations. Although the

³Included in the \$550.3 billion were two large adjustments totaling \$436 billion for the actuarial liability for health benefits for DoD military personnel. These adjustments did not relate to recommendations in the prior audit.

⁴Appropriations are closed by the U.S. Treasury 5 years after obligation authority expires and remaining balances are canceled, in accordance with title 31, United States Code, Section 1553.

Finding A. Compilation of Financial Statements

\$68 million was not material to the overall financial statements for Other Defense Organizations, procedures should be established to ensure accounts receivable from closed appropriations are appropriately reported as required. In future years, the amounts may be material to future financial statements.

Information Provided to DFAS Indianapolis Center

Incomplete financial information that supporting accounting offices provided to DFAS Indianapolis Center decreased the reliability and accuracy of the FY 1997 Financial Statements for Other Defense Organizations.

Summary Accounts. The DFAS Indianapolis Center issued a memorandum on August 11, 1997, to Defense Accounting Offices instructing the Offices not to use summary accounts when reporting general ledger trial balances. However, FY 1997 year-end trial balances showed that the supporting accounting offices continued to use summary accounts to report general ledger trial balances. The supporting accounting offices used 19 summary accounts to report \$19 billion in debit balances and \$5 billion in credit balances for FY 1997, rather than using the posting accounts, as required by DoD Regulation 7000.14-R. The DFAS Indianapolis Center was unable to obtain details from the supporting accounting offices on specific information in the summary accounts because of time constraints in preparing adjusted trial balances for the financial statements required by the CFO Act.

Reporting financial information using summary accounts did not affect the total balances in the financial statements. However, the reliability of the individual lines in the financial statements and the Notes associated with these lines could not be tested by us nor DFAS Indianapolis Center without complete supporting documentation.

Submission of Trial Balances for Other Defense Organizations. Reporting entities included within Other Defense Organizations did not always submit the needed financial information to DFAS Indianapolis Center in a timely or complete manner. As of the October 31, 1997, deadline established by DFAS to provide trial balances, compilation personnel in DFAS Indianapolis Center had not received complete trial balances for 36 of the 44 Defense organizations, funds, and accounts included in Other Defense Organizations. Also DFAS Indianapolis Center was required to prepare at least seven trial balances from non-general ledger data because activities did not prepare required trial balances. These problems are addressed in IG, DoD Report No. 99-006.

Conclusion

The DoD and the DFAS have acknowledged the long-standing problems of the lack of compliant accounting systems and audit trails and have undertaken numerous actions to correct the reported problems. However, deficiencies in accounting systems and audit trails may not be fully corrected for years. While waiting for a permanent solution, the DFAS Indianapolis Center could improve

Finding A. Compilation of Financial Statements

the reliability of the financial statements by implementing corrective actions identified in prior IG, DoD audit reports and the specific problems cited in this report.

Recommendations for Corrective Action

We recommend that the Director, Defense Finance and Accounting Service Indianapolis Center, establish and implement management control procedures to comply with the most current Office of Management and Budget and DoD guidance on Form and Content of Financial Statements. Specifically,

A.1. Establish procedures to coordinate with the Other Defense Organizations and accounting offices that support the Other Defense Organizations when making adjustments to trial balance submissions.

A.2. Report amounts for Accounts Payable and Accounts Receivable from closed appropriations as required by DoD Form and Content Guidance.

A.3. Document and maintain complete audit trails for all year-end adjustments made to the Other Defense Organizations trial balances in accordance with Key Accounting Requirement No. 8, "Audit Trails."

A.4. Advise and assist the accounting offices that support the Other Defense Organizations to discontinue using summary and obsolete accounts.

Management Comments Required

DFAS did not comment on a draft of this report. We request that DFAS comment on the final report.

Finding B. Reporting Fund Balance With Treasury

The DFAS Indianapolis Center reduced the Fund Balance with Treasury reported in trial balances for Entity Assets by \$5.3 billion to match the Department of Treasury records without reconciling the differences. Also, the Fund Balance with Treasury for Non-Entity assets was overstated by \$1 billion. These conditions occurred because the DFAS Indianapolis Center did not:

- follow Federal and DoD requirements to research and reconcile the discrepancies between the Defense organizations' accounting records and the Department of Treasury's accounting records when preparing the FY 1997 financial statements for Other Defense Organizations, and
- monitor and reconcile Budget Clearing Accounts.

As a result, Fund Balance(s) with Treasury reported in the FY 1997 Statement of Financial Position for Other Defense Organizations were inaccurate and could not be relied on. Unless, improvements in the reconciliation process are made, the financial statements for Other Defense Organizations will not be in compliance with CFO reporting requirements.

Financial Accounting and Reporting Requirements

Federal and DoD Policy. The Statement of Federal Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," March 30, 1993, requires Federal entities to reconcile and explain any discrepancies between Fund Balance with Treasury amount in their general ledger accounts and the balance in the Department of Treasury's accounts and to explain the cause of the discrepancies in the footnotes to the financial statements. Also, discrepancies due to time lags should be reconciled, and discrepancies due to errors should be corrected when financial statements are prepared. DoD Regulation 7000.14-R implemented this policy for DoD in volume 4.

DoD Regulation 7000.14-R, volume 6, also provides additional guidance in chapter 2, "Departmental Financial Reports Roles and Responsibilities," February 1996. Chapter 2 requires DFAS to identify the requirement for adjustments to financial data and to adequately support and justify in writing, any adjustment made to the official accounting records. Specifically, DFAS must:

Finding B. Reporting Fund Balance with Treasury

- establish procedures to ensure that all general ledger balances and other associated financial balances are reconciled, at least on a quarterly basis;
- investigate, document, and process unreconciled differences in accordance with applicable provisions of the regulation to balance the general ledger amount with the amount of the subsidiary records; and
- identify unreconciled differences between the general ledger records that exceed \$1 million. The reconciliation shall be performed on a monthly basis to determine the cause of the differences and to take appropriate actions to ensure the accuracy and integrity of the accounting system and monthly reports. Further, certain adjustments proposed by the DFAS must be reviewed and approved by the customer before the adjustment is recorded.

Reconciliation with the Department of Treasury

Differences Between Department of Treasury Records and Trial Balances. As of September 30, 1997, accounting records for Other Defense Organizations maintained by supporting Defense accounting offices showed that the Fund Balance with Treasury for Entity Assets was \$5.3 billion more than the Department of Treasury accounting records. Because funds used by Other Defense Organizations are held in the U.S. Treasury, the DFAS Indianapolis Center arbitrarily adjusted its Fund Balance with Treasury for Other Defense Organizations to equal the amount reported by the Treasury.

Responsibility for Department 97 reporting was transferred to the DFAS Indianapolis Center effective April 1, 1995. However, as of September 30, 1997, the DFAS had not established adequate procedures to coordinate with supporting Defense accounting offices in investigating and resolving the discrepancies between the amounts in the Defense organizations' accounting records and the Department of the Treasury's accounting records. The DFAS Indianapolis Center personnel stated that they were working to increase access to detailed transactions from the supporting accounting offices that would allow for the reconciliation of Treasury records in FY 1998.

Notifying Defense Organizations of Adjustments Made to the General Ledger. The DFAS Indianapolis Center did not notify supporting accounting offices to obtain feedback or approval before \$5.3 billion in adjustments were recorded. DoD Regulation 7000.14-R, volume 6, specifies six exceptions that allows the DFAS to make adjustments without prior approval from the Defense Organizations. However, our review showed that none of the exceptions were pertinent to the \$5.3 billion in adjustments. DFAS Indianapolis Center should coordinate with affected Defense organizations before recording adjustments to Fund Balance with Treasury reported in trial balances of Other Defense Organizations.

Finding B. Reporting Fund Balance with Treasury

Reporting Non-Entity Fund Balance With Treasury

The FY 1997 Non-Entity Fund Balance with Treasury for Other Defense Organizations was overstated by about \$1 billion because the DFAS Indianapolis Center did not establish procedures to monitor and reconcile the Budget Clearing Account balances as required.

Budget Clearing Accounts. The Department of Treasury established Clearing Accounts to hold collections temporarily pending clearance to the applicable receipt or expenditure account. However, the Treasury Financial Manual, chapter 1500 states that agencies should make every effort to keep the balances in Clearing Accounts to a minimum by transferring funds initially classified in Clearing Accounts to the proper ones as soon as possible. To comply with the above requirement, agencies should monitor Clearing Accounts on a continuous basis. The DFAS Indianapolis Center is required to report the status of all Clearing Accounts to the DFAS Headquarters on a quarterly basis.

Monitoring and Reporting Non-Entity Fund Balance with Treasury Account. OMB and DoD Form and Content Guidance require that balances in Deposit, Suspense, and Clearing Accounts that are not available to finance the entity's activities be reported as Fund Balance with Treasury for Non-Entity Assets, line 2. a(1) of the Statement of Financial Position. The DFAS Indianapolis Center reported \$148 million for Non-Entity Fund Balance with Treasury in the Statement of Financial Position. However, the September 30, 1997 "Report(s) on Budget Execution" showed a negative balance of \$809 million for the Budget Clearing Account (97F3875). The differences between the two records was about \$1 billion. This problem occurred because the DFAS Indianapolis Center did not establish procedures to monitor and reconcile Budget Clearing Account balances until September 1997. Accordingly, the DFAS Indianapolis Center could not determine the correct balance for the FY 1997.

During FY 1997, the DFAS Indianapolis Center recognized that their accounting system was not capable of generating the necessary data to establish and verify the value for the Budget Clearing Accounts. To meet its quarterly reporting requirements, on September 19, 1997, the DFAS Indianapolis Center requested the supporting accounting offices to provide information for certain deposit fund and budget clearing accounts by October 15, 1997, and by 15th of each succeeding month. However, as of March 5, 1998, the DFAS Indianapolis Center had not been able to determine the supportable amount for the Budget Clearing Accounts.

Because the DFAS Indianapolis Center already identified the reconciliation of Clearing Accounts for Defense agencies as an uncorrected material weakness in the FY 1997 Annual Statement of Assurance, and took actions to request additional information from the Defense agencies on the Budget Clearing Accounts to meet the quarterly reporting requirement, we are not making a recommendation to monitor the status of the Budget Clearing Accounts for Other Defense Organizations.

In addition, representatives from the Office of Management and Budget, General Accounting Office, Under Secretary of Defense (Comptroller), Defense Finance

Finding B. Reporting Fund Balance with Treasury

and Accounting Service, and the Inspector General, DoD, have made Fund Balance with Treasury one of the issues included in a joint implementation strategy designed to achieve favorable audit opinions.

Recommendations for Corrective Action

We recommend that the Director, Defense Finance and Accounting Service Indianapolis Center:

B.1 Prepare a plan of action and milestones to verify that the discrepancies between the Defense organizations' accounting records and the Department of Treasury's accounting records are reconciled on a monthly basis and when the consolidated financial statements are prepared.

B.2 Establish processes and procedures to coordinate adjustments with the supporting accounting offices or Defense organizations to determine the causes of the differences and obtain agreement from the affected Defense organizations before adjustments are recorded to Fund Balance with Treasury.

Management Comments Required

DFAS did not comment on a draft of this report. We request that DFAS provide comments on the final report.

Finding C. Notes to Financial Statements

Notes to the FY 1997 financial statements prepared by the DFAS Indianapolis Center were not adequate, not complete, nor in compliance with OMB and DoD Form and Content Guidance. For example, the DFAS Indianapolis Center did not adequately explain 7 significant account balance variances ranging from over \$559 million to \$4.1 billion in the comparative financial statements for Other Defense Organizations. These conditions occurred because the DFAS Indianapolis Center:

- had not corrected conditions relating to the financial statement disclosures identified in a previous IG, DoD, audit report,
- did not fully comply with Office of Management and Budget and DoD Form and Content Guidance, and
- did not have sufficient information from Defense accounting offices providing trial balances for the Other Defense Organizations.

As a result, the FY 1997 Notes to the financial statements prepared by the DFAS Indianapolis Center were not comprehensive or complete.

Issues Identified in Prior IG, DoD, Audit Report

The IG, DoD, Report No. 98-062, "Compilation of the FY 1996 Financial Statements for Other Defense Organizations," February 4, 1998, stated that the DFAS Indianapolis Center did not prepare all required Notes to the financial statements, and when prepared, the Notes were not accurate and not complete. Although DFAS Indianapolis Center corrected some deficiencies discussed in the prior audit, several conditions continued to exist.

Note 2 (Fund Balance with Treasury). Additional disclosures in Note 2 for both Entity and Non-Entity Fund Balances with Treasury would increase the usefulness of Note 2 and more fully comply with OMB and DoD Form and Content Guidance.

Entity Assets. Note 1.G to the financial statements states that Fund Balance with Treasury was adjusted to agree with Treasury records. However, the DFAS Indianapolis Center did not disclose the amount of the \$5.3 billion adjustment in Notes 1 or 2. (See Finding B for a discussion of the \$5.3 billion adjustment).

Non-Entity Assets. The DFAS Indianapolis Center prepared a schedule supporting the \$147.8 million in Non-Entity fund balances in Note 2. However, the disclosure did not explain why the activity occurred or whether the amount was a deposit, suspense, or clearing account. The OMB Bulletin No. 94-01 requires the reporting entity to disclose all balances in deposit,

Finding C. Notes to Financial Statements

suspense, and clearing accounts that are not available to finance the entity's activities, and to report the amount on the Statement of Financial Position as Non-Entity Assets.

Note 15 (Property, Plant, and Equipment). Note 1.M, "Property, Plant, and Equipment" correctly stated that the lack of integration between DoD property and accounting systems creates the potential for misstatements. However, Note 15 did not mention any problems regarding the reliability of Property, Plant, and Equipment. The FY 1997 DoD Annual Statement of Assurance states that the accounting systems could not produce reliable account balances for Property, Plant, and Equipment and that recent financial statement audits found the balances for real and personal property were unreliable. The financial statements would be more complete if Note 15 briefly described problems with the reliability of Property, Plant, and Equipment and referenced the reader to comments in Note 1.M.

Note 28 (Non-Operating Changes). The DFAS Indianapolis Center did not disclose in Note 28, that FY 1997 adjustments to Transfers-In (GLAC 3220) and Transfers-Out (GLAC 3231), totaling \$3.77 billion and \$837 million respectively, were not related to the actual transfer of assets to or from the Defense Organizations. Instead, adjustments were used as transfer balances for two obsolete accounts, Cumulative Results of Operations (GLAC 3318) and Net Results of Operations (GLAC 3328), and as offset accounts to make the debit and credit balances equal.

Accounts Payable Abnormal Balance. The Statement of Operations line 4.b.1., "Accounts Payable Transactions with Non-Federal Entities," showed a negative balance of \$411.6 million. However, DFAS Indianapolis Center did not prepare a note explaining the cause or reason for the negative balance.

Additional Disclosures

Additional disclosures in four Notes to the financial statements would make the financial statements more useful and more fully compliant with the OMB and DoD Form and Content Guidance.

Note 1 (Statement of Significant Accounting Policies). DFAS Indianapolis could improve the usefulness of Note 1 and more closely comply with DoD Form and Content Guidance by adding required information to Note 1.C (Budgets and Budgetary Accounting) and Note 1.F (Accounting for Intra-Governmental Activities).

Budgets and Budgetary Accounting. Note 1.C did not include the number of General, Special, and Deposit fund accounts, or the number and amount of accounts funded through current and multi-year appropriations as required by DoD Form and Content Guidance. Also, the note did not specify if Revolving Funds operated at a profit or deficit.

Finding C. Notes to Financial Statements

amount agencies contribute to the Civil Service Retirement System, the Federal Employees Retirement System, the Military Retirement System, Social Security, and to the Federal Employees Thrift Savings Plan.

Because military personnel are assigned to Other Defense Organizations, but are not funded by Department 97 appropriations, Note 1 should also explain that the actual costs of operating the organizations included in Other Defense Organizations is significantly higher than reported in the financial statements.

Note 19 (Pensions and Other Actuarial Liabilities). Note 19 included liabilities for DoD Education Benefits and Voluntary Separation Allowance. However, the DFAS Indianapolis Center did not provide any explanation on where those liabilities came from or how they were derived. The OMB Bulletin No. 97-01 requires the minimum disclosure of total liability and separate amounts covered by budgetary resources and not covered by budgetary resources, the assumptions used to calculate the liability, and the individual components of expense for the period. Problems related to the disclosure of the reported \$218 billion Pension and Health Benefits are discussed in IG, DoD, Report No.99-010, "Audit of DoD Military Health Retirement Benefits Liability for FY 1997," October 9 1998.

Note 28 (Non-Operating Changes). The DoD Form and Content Guidance requires in Note 28 the disclosure of comparative financial information from year to year. However, the DFAS Indianapolis Center did not show the FY 1996 increases and decreases to Non-Operating Changes. The Note also did not disclose the reason for the \$941.9 million abnormal account balance in Non-Operating Changes (Line 23).

Note 30 (Contingencies). DFAS Indianapolis Center did not accurately disclose conditions, situations, or sets of circumstances involving uncertainty as required by the DoD Form and Content Guidance in Note 30. Instead, DFAS Indianapolis Center made a general statement that Other Defense Organizations are subject to various assorted claims of over \$100 million. That statement was copied from the FY 1997 Department of the Army Financial Statements.

Comparative Financial Statement Disclosures

The DFAS Indianapolis Center did not explain the causes for large variances in the financial statements line items from year to year IG, DoD, Report No. 96-161, "Compilation of FY 1995 and FY 1996 DoD Financial Statements at the Defense Finance and Accounting Service, Indianapolis Center," June 13, 1996, states that footnotes did not accurately explain the causes for large variances in financial statement line items from year to year. The report recommended the DFAS Indianapolis Center develop and implement procedures for fully explaining large line item variances from year to year that were greater than \$500 million and at least 25 percent of the account balance. However, the comparative financial statements for FYs 1997 and 1996 for Other Defense Organizations contained 7 line items with unexplained variances greater than \$500 million and at least 25 percent of the account balance. The following table shows the FYs 1996 and 1997 account balances and the percent difference from year to year for the seven significant variances.

Finding C. Notes to Financial Statements

\$500 million and at least 25 percent of the account balance. The following table shows the FYs 1996 and 1997 account balances and the percent difference from year to year for the seven significant variances.

Comparison of FY 1997 and FY 1996 Line Items on Financial Statements With Significant Variances (\$ in millions)				
<u>Financial Statement Line Item</u>	<u>FY 1997</u>	<u>FY 1996</u>	<u>Absolute Difference</u>	<u>Percent Difference</u>
<u>Statement of Financial Position</u>				
Accounts Receivable Federal	\$1,619	\$ 1,060	\$ 559	53
Accounts Receivable Non-Federal	1,483	140	1,343	963
Inventory	112	1,620	1,508	-93
Accounts Payable Federal	791	1,468	677	-46
Accounts Payable Non-Federal	(412)	(1,986)	1,574	-79
<u>Statement of Operations and Changes in Net Position</u>				
Revenues-Intragovernmental	912	4,972	4,060	-82
Non-Operating Changes	(942)	882	1,824	-207

DFAS Indianapolis Center did not provide reasons why the large variances ranging from \$559 million to \$4 billion occurred or why it was unable to determine the cause of the large variances. The DFAS Indianapolis Center accounting personnel stated that the variances were not fully documented because desirable information was scattered over 40 organizations and funds and the DFAS Indianapolis Center did not receive information on the causes of the variances from accounting offices reporting the financial information. However, there was no evidence to show that the DFAS Indianapolis Center analyzed the differences or tried to obtain reasons for variances from the Other Defense Organizations. At least one organization provided the DFAS Indianapolis Center with a reason for a significant variance. The National Imagery and Mapping Agency stated in a memorandum to the DFAS Indianapolis Center that reported inventory for FY 1997 of \$36 million was significantly less than the \$1.35 billion reported in FY 1996. The large decrease occurred because the National Imagery and Mapping Agency stated that it changed its valuation procedures to more truly reflect the cost of the mapping products produced.

The DFAS Indianapolis Center also was not able to fully explain significant variances in line item balances from year to year because the DFAS Indianapolis Center did not have the beginning balances for the comparative financial statements. Because of the lack of complete standard general ledger accounting systems, the DFAS Indianapolis Center made summary-level adjustments to force the Other Defense Organizations' general ledger to equal the "Report(s) on Budget Execution" prior to producing the financial statements. However, those adjustments were not properly coordinated with the affected Defense organizations to determine the causes of the discrepancies or to update their accounting records if necessary. Consequently, the ending balances reported by

Finding C. Notes to Financial Statements

the Defense organizations were not the same as the ending balances reported by the DFAS Indianapolis Center. The DFAS Indianapolis Center accounting personnel stated that there was no relationship between the FY 1996 data and FY 1997 data because every year was a new year.

Conclusion

DFAS Indianapolis Center added and improved information disclosed in the Notes to the FY 1997 financial statements for Other Defense Organizations. However, additional improvements would make the Notes more informative and compliant with OMB and DoD Form and Content Guidance. Increased attention in adhering to OMB and DoD Form and Content Guidance will ensure that the Notes to the financial statements will provide more comprehensive and reliable information and that diversions from generally accepted accounting principles and DoD policy are fully documented and explained.

Recommendations for Corrective Action

We recommend that the Director, Defense Finance and Accounting Service Indianapolis Center establish and implement procedures to:

C.1. Comply with the most current Office of Management and Budget and Department of Defense Form and Content Guidance when preparing Notes to the financial statements. Specifically, the Notes to the financial statements should:

a. Disclose in Note 2 that Fund Balance with Treasury is adjusted to reflect the balances from the Department of Treasury's accounting records and the composition of Non-Entity assets included in Fund Balance with Treasury.

b. Disclose in Note 15 that DoD accounting systems could not produce reliable account balances for Property, Plant, and Equipment.

c. Describe in Note 28 whether the adjustments to General Ledger Accounting Code 3220 and 3231 are related to the actual transfer of assets to or from the Defense organizations.

d. Disclose reasons and causes for abnormal (negative) balances in the financial statements.

e. Disclose the information required in Note 1.C (Budgetary Accounting) and Note 1.F (Accounting for Intra-Governmental Activities), and disclose that costs for military personnel are not include in financial data for Other Defense Organizations.

Finding C. Notes to Financial Statements

f. Disclose in Note 19 the total liability of other retirement expenses and separate amounts covered and not covered by budgetary resources, the assumptions used to calculate the liability, and the individual components of expense for the period.

g. Show in Note 28 for comparative purposes the prior year increases and decreases to Non-Operating Changes with the subsequent year Non-Operating Changes.

h. Disclose in Note 30 specific conditions, situations, or circumstances involving Other Defense Organization uncertainties.

C.2. Request accounting offices supporting Other Defense Organizations to explain the reasons or causes for large variances from the prior fiscal year in account balances included in reported trial balances.

C.3. Disclose the nature of any significant account balance variance in excess of \$500 million and 25 percent of the balances for specific line items from the prior year comparative financial statements.

Management Comments Required

DFAS did not comment on a draft of this report. We request that DFAS provide comments on the final report.

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Part II - Additional Information

Appendix A. Audit Process

Scope

We reviewed the September 30, 1997, "Report(s) on Budget Execution," and the FY 1997 Other Defense Organizations' Financial Statements and Notes. The 44 Defense organizations, funds, and accounts included in the Other Defense Organizations showed total assets of \$46.5 billion, total liabilities of \$222.2 billion, revenues and financing sources of \$50 billion, and expenses of \$49.7 billion. We reviewed the documentation for the 129 year-end adjustments, totaling \$550.3 billion, that the DFAS Indianapolis Center made to individual and consolidated trial balances.

DoD-wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Department of Defense has established 6 DoD-wide corporate-level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal:

Objective: Fundamentally reengineer the Department and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD missions areas. (DoD-6)

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal:

Financial Management Objective: Strengthen internal controls. **Goal:** Improve compliance with Federal Managers' Financial Integrity Act. (FM-5.3)

General Accounting Office High Risk Area. The General Accounting Office has identified several high risk areas in the Department of Defense. This report provides coverage of the Defense Financial Management high risk area.

Methodology

We used the 1997 "Report(s) on Budget Execution" to calculate the amount of accounts receivable and accounts payable for canceled appropriations that should have been reported in the Other Defense Organizations financial statements. We also compared the information in the Notes to the financial statements with requirements in OMB and DoD Form and Content Guidance. We did not attempt to validate the reliability or accuracy of the trial balances submitted by accounting offices supporting Other Defense Organizations.

Use of Computer-Processed Data. We used computer-processed data without confirming the reliability of the data because the accounting systems in DoD that support the Other Defense Organizations financial statements have significant limitations. The lack of reliable financial information was recognized as a material management control deficiency in the DoD FY 1997 Annual Statement of Assurance; however, the lack of reliable information does not adversely affect the results of the audit.

Audit Type, Dates, and Standards. We performed this financial-related audit from December 1997 through May 1998 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the IG, DoD, based on the objectives of the audit and the limitations described in this appendix. Accordingly, we included tests of internal controls considered necessary.

Contacts During the Audit. We visited or contacted individuals at the DFAS Indianapolis Center. Further details are available on request.

Prior Audit Coverage

The IG, DoD, has published numerous audit reports in response to the requirements of the CFO Act. The 11 reports below issued during FY 1997 and 1998 included specific information related to the current audit.

Report No. 99-010, "Audit of DoD Military Health Retirement Benefits Liability for FY 1997," October 13, 1998.

Report No. 99-006, "Consolidation Process for FY 1997 Financial Statements for Other Defense Organizations," October 6, 1998.

Report No. 98-178, "Internal Controls and Compliance with Laws and Regulations for the FY 1997 Financial Statements of Other Defense Organizations," July 13, 1998.

Report No. 98-062, "Compilation of the FY 1996 Financial Statements for Other Defense Organizations," February 4, 1998.

Report No. 98-029, "Revenues and Expenses from Reimbursable Activity for Other Defense Organizations," December 5, 1997.

Report No. 98-027, "Comprehensiveness of the FY 1996 Other Defense Organizations Financial Statements," November 28, 1997.

Report No. 97-225, "Major Deficiencies Preventing Favorable Audit Opinions on the FY 1996 DoD General Fund Financial Statements," September 30, 1997.

Report No. 97-215, "Reporting of Accounts Payable for the National Guard and Reserve Equipment Appropriation on the 'Other Defense Organizations' Portion of the FY 1996 Financial Statements," September 18, 1997.

Appendix A. Audit Process

Report No. 97-155, "Internal Controls and Compliance with Laws and Regulations for the FY 1996 Financial Statements of the 'Other Defense Organizations' Receiving Department 97 Appropriations," June 11, 1997.

Report No. 97-151, "The Fund Balance with Treasury Account for the Research, Development, Test and Evaluation Appropriation, Department 97," June 4, 1997.

Report No. 97-079, "Documentation of the Federal Financial System Process at the Defense Finance and Accounting Service Indianapolis Center," January 24, 1997.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
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Auditor General, Department of the Army

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

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

Unified Command

Commander in Chief, U.S. Special Operations Command

Other Defense Organizations

Director, Defense Advanced Research Projects Agency
Director, Ballistic Missile Defense Organization
Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Information Systems Agency
Director, Defense Intelligence Agency
Inspector General, Defense Intelligence Agency
Director, Defense Security Service
Director, Defense Legal Services Agency
Director, Defense Logistics Agency
Director, Defense Special Weapons Agency
Director, National Imagery and Mapping Agency
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Appendix B. Report Distribution

Other Defense Organizations (cont'd)

Director, National Security Agency
Inspector General, National Security Agency
Director, On-Site Inspection Agency
Director, American Forces Information Service
Director, Defense Medical Programs Activity
Director, Defense Prisoner of War/Missing in Action Office
Director, Defense Technology Security Administration
Director, Department of Defense Education Activity
Director, Office of Civilian Health and Medical Program of the Uniformed Services
Director, Office of Economic Adjustment
Director, Washington Headquarters Services
President, Uniformed Services University of the Health Sciences

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division,
General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight
House Committee on National Security

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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