

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

**JOINT LOGISTICS SYSTEMS CENTER REPORTING
OF SYSTEMS DEVELOPMENT COSTS**

Report No. 98-060

February 3, 1998

Department of Defense

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Acronyms

DBOF	Defense Business Operations Fund
JLSC	Joint Logistics Systems Center
USD(C)	Under Secretary of Defense (Comptroller)
WCF	Working Capital Funds



INSPECTOR GENERAL
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February 3, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
COMMANDER, JOINT LOGISTICS SYSTEMS CENTER

**SUBJECT: Audit Report on Joint Logistics Systems Center Reporting of Systems
Development Costs (Report No. 98-060)**

We are providing this final report for review and comments. This audit was performed to meet requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. The Under Secretary of Defense (Comptroller) did not comment on the draft of this report. DoD Directive 7650.3 requires that all unresolved issues be resolved promptly. Therefore, we request that the Under Secretary of Defense (Comptroller) provide comments on this report by March 2, 1998. If delayed comments on the draft report are received, they will be considered as the response to the final report, unless you indicate otherwise.

The courtesies extended to the audit staff are appreciated. Questions on this audit should be directed to Mr. James L. Kornides, Audit Program Director, at (614) 751-1400, extension 11, e-mail JKornides@DODIG.OSD.MIL, or Mr. John K. Issel, Audit Project Manager, at (614) 751-1400, extension 12, e-mail JIssel@DODIG.OSD.MIL. See Appendix C for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-060
Project No. 7FJ-2027

February 3, 1998

Joint Logistics Systems Center Reporting of Systems Development Costs

Executive Summary

Introduction. This audit was performed to meet the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," as amended by Public Law 103-356, the "Federal Financial Management Act of 1994." The Joint Logistics Systems Center (JLSC) was organized in FY 1992 to accomplish Corporate Information Management goals for the depot maintenance and supply management business areas of the DoD Working Capital Funds. Specifically, the JLSC served as a central agent with the responsibility for managing the design, development, and implementation of DoD-wide automated information systems for depot maintenance and supply management. As of the end of FY 1996, the JLSC reported \$1.3 billion in systems development costs on its annual financial statements. To obtain funds to cover JLSC system development costs, the Under Secretary of Defense (Comptroller) required each of the depot maintenance and supply management business areas of the DoD Working Capital Funds to charge additional costs to their customers, primarily Military Department operational units, for goods or services provided. Those surcharges total nearly \$2 billion through FY 1998.

Audit Objective. The overall audit objective was to determine the reliability of information presented in the property, plant, and equipment accounts of the JLSC financial statements. We also determined whether the costs of the JLSC systems developments were appropriately transferred to the organizations that would operate the systems for capitalization. Additionally, we assessed the Under Secretary of Defense (Comptroller) policy on the recovery of depreciation costs for the JLSC systems developments.

Audit Results. The JLSC did not transfer about \$1.54 billion of systems development costs, incurred through the end of FY 1996, to the depot maintenance and supply management organizations responsible for capitalizing and reporting these costs on the financial statements. Additionally, the \$1.54 billion and another \$460 million in development costs to be incurred through FY 1998 will be improperly charged, through the recovery of depreciation costs, to customers of the depot maintenance and supply management business areas of the DoD Working Capital Funds. As a result, the JLSC FY 1996 financial statements were materially overstated, and unless the systems development costs are properly transferred to the appropriate organizations, the financial statements for FY 1997 and beyond will continue to be overstated. Conversely, the financial statements of the organizations that received the capital assets (that is, systems developments) will be understated. Also, unless the depreciation costs of the JLSC systems developments are recorded as unfunded costs, customers of the DoD Working Capital Fund organizations that received the systems developments will have to pay again for nearly \$2 billion in development costs.

The recommendations in this report, if implemented, will improve the reliability of the JLSC financial statements. Implementing the recommendations will also allow the depot maintenance and supply management business areas of the DoD Working Capital Funds to reduce, by nearly \$2 billion, the costs of providing goods and services to customers. See Part I for a discussion of the audit results and Appendix B for a summary of potential benefits.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) provide guidance to the JLSC on how to equitably allocate the costs of systems developments to the appropriate DoD Working Capital Fund organizations and direct that those organizations properly capitalize and report in their financial statements the costs incurred by the JLSC for systems developments. Also, we recommend that JLSC systems developments be exempt from the recovery of depreciation costs because those depreciation costs were essentially recovered when the costs of system developments were paid for previously. Instead, depreciation of JLSC systems developments should be recorded on accounting records in an unfunded depreciation account to avoid duplicate payments by customers.

Management Comments. The Under Secretary of Defense (Comptroller) did not comment on the draft report. Therefore, we request that the Under Secretary of Defense (Comptroller) provide comments on the final report by March 2, 1998. The Commander, JLSC, provided unsolicited comments on the draft report. He concurred with the finding and stated that he believed the report was factually correct. He emphasized that JLSC could not properly transfer the costs of developments or completed systems to the receiving organizations for capitalization because guidance from the Under Secretary of Defense (Comptroller) was lacking. See Part III for the text of the JLSC comments.

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Part I - Audit Results

Audit Background

This audit was performed to meet requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," as amended by Public Law 103-356, the "Federal Financial Management Act of 1994."

Joint Logistics Systems Center. The Joint Logistics Systems Center (JLSC) was organized in FY 1992 to accomplish Corporate Information Management goals for the depot maintenance and supply management business areas of the DoD Working Capital Funds (WCFs). Specifically, the JLSC served as a central agent responsible for managing the design, development, and implementation of automated information systems for DoD-wide depot maintenance and supply management. Each year since its inception, the JLSC reported the costs it incurred for systems development in its annual financial statements. The JLSC reported system development costs of \$1.3 billion in its FY 1996 financial statements. Those costs were reported as construction-in-process.

The Under Secretary of Defense (Comptroller) (USD[C]) had budgeted nearly \$2 billion through FY 1998 for the JLSC to develop information systems for depot maintenance and supply management.

Capital Asset Policy. The USD(C) is responsible for developing accounting and reporting policy for capital assets of WCF organizations. DoD 7000.14-R, the "DoD Financial Management Regulation," volume 11B, "Reimbursable Operations, Policy and Procedures -- Defense Business Operations Fund," December 1994, gives the requirements for asset capitalization and depreciation. DoD 7000.14-R requires WCF organizations to capitalize and report all assets, referred to as capital assets, having an acquisition value of \$100,000 or greater and a useful life of 2 or more years. Capital assets include, but are not limited to, physical plant and property (including minor construction), equipment, and automated information systems. The costs of capital assets are depreciated over a varying number of years, based on the estimated useful life of the asset. For example, the USD(C) policy requires that equipment items be depreciated over 10 years and automated information systems be depreciated over 5 years unless another estimated useful life is justified.

Audit Objectives

The audit objective was to determine the reliability of information presented in the property, plant, and equipment (capital asset) accounts of the JLSC financial statements. We also determined whether the costs of JLSC system developments were appropriately transferred to the organizations that would be operating the systems for capitalization. Additionally, we assessed the propriety of USD(C) policy on the recovery of depreciation costs for JLSC system developments. See Appendix A for a discussion of the scope, methodology, and prior audit coverage, and Appendix B for a summary of potential benefits.

Transfer of Costs and Recovery of Depreciation for Systems Development

The JLSC did not transfer about \$1.54 billion of systems development costs, incurred as of the end of FY 1996, to depot maintenance and supply management organizations for capitalization and financial reporting. Additionally, about \$2 billion in JLSC systems development costs to be incurred through FY 1998 will be improperly charged, through the recovery of depreciation costs, to customers of the WCF depot maintenance and supply management business areas. These conditions existed because:

- o the USD(C) did not provide adequate guidance to the JLSC on how to equitably allocate the systems development costs to WCF depot maintenance and supply management organizations so that those organizations could capitalize and report the value of the capital assets received, and

- o USD(C) funding policy for WCF organizations requires organizations that receive JLSC systems developments to recover the depreciation costs of capital assets through additional charges to their customers, primarily Military Department operational units, for goods or services provided to these customers.

As a result, the JLSC FY 1996 financial statements were materially overstated, and unless the JLSC systems developments are properly transferred to the appropriate WCF organizations, JLSC financial statements for FY 1997 and beyond will also be overstated. Conversely, the financial statements of the organizations that received the capital assets (that is, systems developments) were and will continue to be understated. Also, unless the depreciation costs of JLSC systems developments are recorded as unfunded costs, customers of the WCF organizations that receive JLSC systems developments will pay again for nearly \$2 billion in systems development costs.

Capital Assets Centrally Acquired

DoD 7000.14-R provides accounting policy for capital assets that are acquired by a central agent, such as the JLSC, on behalf of the WCF organizations. The Regulation states:

1. Business areas, such as the Joint Logistics Systems Center, may from time to time be designated as a central agent to procure capital

Transfer of Costs and Recovery of Depreciation for Systems Developments

assets for customers within the former Defense Business Operations Fund (DBOF), now the WCFs. The procuring business area shall issue contracts to commercial sources or funded orders to other DBOF activities and DoD Components as necessary, to satisfy the requirement.

2. Capital assets may be sold or transferred to customers of the central agent at negotiated selling or transfer prices. Negotiated selling or transfer prices shall include the total cost of the capital asset which consists of contractual cost net of discounts taken, reimbursable support cost, applicable overhead, general and administrative costs incurred in the acquisition of the asset plus any approved surcharges.

3. A capital asset acquired by a central agent and distributed and installed in one or more business areas shall be capitalized in the financial records of each business area and depreciated.

4. When the share of the cost of a capital asset distributed and installed at a business area fails to meet the investment capitalization criteria, it nevertheless shall be capitalized and depreciated if the aggregate initial cost of the asset distributed to all business areas, satisfies the investment threshold.

Transfer of Development Costs

JLSC Costs. The JLSC complied with the USD(C) policy and initially recorded in its financial records, as construction-in-process, costs incurred for the development of depot maintenance and supply management information systems. However, when the systems were delivered and installed at various WCF organizations, the JLSC did not properly transfer the costs of development to the receiving organizations for capitalization. By the end of FY 1996, JLSC systems developers estimated that they had incurred about \$1.54 billion in development costs. Of the total \$1.54 billion in development costs, about \$1.04 billion represents the costs of developing systems that had been installed and were operating at various WCF organizations. For example, by the end of FY 1996, the JLSC had installed the Programmed Depot Maintenance Scheduling System, which cost over \$24 million, at 21 depot maintenance sites.

In addition to the installed systems, the remaining \$500 million in development costs incurred by the JLSC was spent on systems that have been canceled because of a change in the Corporate Information Management goal of developing DoD-wide systems. For example, the JLSC had incurred costs of

Transfer of Costs and Recovery of Depreciation for Systems Developments

about \$111 million for the Materiel Management Standard System before it was canceled. These costs are still shown on JLSC financial records as construction-in-process.

Allocation of Systems Development Costs. JLSC management told us that they did not transfer systems development costs because they were unsure how to properly implement USD(C) financial policy for systems that had been installed, and DoD financial policy did not address accounting for the costs incurred for systems that had been canceled. The JLSC had requested that the USD(C) provide guidance on the proper method of allocating its development costs as early as September 1994, but the USD(C) responded that this issue should be brought to the attention of the former Defense Business Operations Fund Corporate Board (now the WCF Policy Board). The issue has not been presented to the WCF Policy Board, and the JLSC has not allocated its development costs to the various WCF organizations.

To allocate the common development costs for systems that had been placed in operation, the JLSC could have equitably distributed costs according to the percentage of funding provided to the JLSC by the WCF organizations. Based on the total funding that each WCF organization was budgeted to provide the JLSC, the total costs of \$1.04 billion for systems installed, and the \$500 million spent on systems that were canceled as of the end of FY 1996, an equitable allocation would be as follows:

**Allocation of JLSC Development Costs
(millions)**

<u>Organization</u>	<u>Total Funding</u>	<u>Percent of Total Funding</u>	<u>Estimated Development Cost</u>	<u>Allocated to WCF Organizations</u>
Army	\$ 404.23	20.90	\$1,540	\$ 322.32
Navy/Marine Corps	696.83	36.10	\$1,540	555.94
Air Force	612.83	31.74	\$1,540	488.80
Defense Logistics Agency	<u>216.71</u>	<u>11.23</u>	\$1,540	<u>172.95</u>
Totals	\$1,930.60	100.00		\$1,540.00

As shown above, the JLSC could have allocated an equitable portion of development costs to WCF organizations based on the percentage of total funding to be provided to the JLSC by those organizations. The WCF organizations actually paying for the developments could have capitalized the costs in accordance with USD(C) policy in DoD 7000.14-R. Relieving the JLSC construction-in-process account by the amount of systems installed and the costs

Transfer of Costs and Recovery of Depreciation for Systems Developments

of canceled systems and capitalizing those costs in the appropriate WCF organization would improve the reliability of JLSC financial reporting of property, plant, and equipment, as well as the reporting by WCF organizations operating the systems.

Effect on Financial Statements. Because JLSC did not transfer the costs of completed systems developments to the WCF organizations that were operating the systems, the FY 1996 JLSC financial statements were materially overstated. The JLSC reported \$1.3 billion for software developments as construction-in-process in FY 1996. However, JLSC senior managers provided us with data showing that of the \$1.3 billion, about \$1.04 billion was for systems that had been developed and were in operation at various WCF organizations. Consequently, the construction-in-process account for systems developments was overstated by at least 80 percent. Additionally, JLSC managers estimated that another \$500 million in costs had been incurred for systems that had been canceled and would not be placed in operation. Those managers attributed the difference in the cost data for completed and canceled systems, \$1.54 billion, and the \$1.3 billion reported in the FY 1996 financial statements, to disbursements for developments that were not shown as liquidated on official accounting records when the FY 1996 financial statements were prepared.

Recovery of Depreciation Costs

Once transferred, approximately \$2 billion of JLSC systems development costs will be improperly charged, through the recovery of depreciation costs, to customers of the WCF depot maintenance and supply management business areas. These customers, primarily Military Department operational units, have already paid for these systems development costs.

Funding of JLSC Developments. The JLSC was budgeted to receive nearly \$2 billion for the development of DoD-wide depot maintenance and supply management information systems through FY 1998. To obtain the required funding for JLSC systems developments, the USD(C) directed that each depot maintenance and supply management business area of the Military Departments and the Defense Logistics Agency give \$1,930.6 million to the JLSC through capital surcharges. Also, \$67.4 million of funds was given to the JLSC from the former DBOF cash account. In order to raise about \$2 billion, the Military Department and Defense Logistics Agency DBOF activities charged their customers higher fees or cost recovery rates for goods or services.

USD(C) Cost Recovery Policy. The USD(C) cost recovery policy in DoD 7000.14-R requires WCF organizations to recover all operating costs by charging fees or cost recovery rates to their customers, primarily military operating units, for providing requested goods or services. In the operating

Transfer of Costs and Recovery of Depreciation for Systems Developments

costs to be passed on to customers, WCF organizations are required to include accumulated operating losses and depreciation costs of capital assets, such as the costs for depreciation of JLSC systems developments when capitalized. The only exception to including depreciation costs in cost recovery rates to be charged to customers is the depreciation of Military Construction-funded properties, since the replacement costs for those facilities are funded by Congress, not the WCF organizations. Depreciation of Military Construction-funded properties is shown in accounting records as unfunded depreciation costs.

Effect on Customer Charges. If the WCF depot maintenance and supply management business areas that receive JLSC systems developments comply with the USD(C) policy to capitalize and include the depreciation costs of those systems in their customer rates, the customers of the WCF business areas will be charged twice for the costs of systems developed by JLSC. Those customers will not only have to pay again for the costs of completed systems (estimated at about \$1,498 million), but will have to pay again for the estimated \$500 million in costs incurred for systems that have been canceled and will never be placed in operation.

In discussions with USD(C) personnel, we were told that completed systems will have to be capitalized and depreciated in accordance with current policy. We were also told that the \$500 million in costs for canceled systems will have to be capitalized and depreciated as research and development or expensed and treated as an operating loss. Either way, the costs will have to be recovered through higher customer rates. However, because the JLSC had previously received funding for its developments through higher charges to WCF customers, we believe it would be inappropriate to include the approximate \$2 billion again, whether for completed or canceled systems developments, in future customer rates.

In addition, the future need for replacing JLSC systems developments is questionable. One of the primary purposes of depreciation accounting is the replacement of older assets. However, because of a change to the Corporate Information Management goals, the requirement no longer exists to develop DoD-wide depot maintenance and supply management systems. Further, the USD(C) program for collecting depreciation costs to purchase new capital assets showed that the program, called the Capital Investment Program, projected a large surplus through FY 1999. Collections were estimated to exceed the requirement for new assets by \$383 million. In the future, if WCF organizations need more capital funds than are being recovered by including depreciation costs in cost recovery rates, then the USD(C) can assess a capital surcharge to make up any shortages.

Transfer of Costs and Recovery of Depreciation for Systems Developments

Summary

Because the JLSC had not transferred about \$1.54 billion of systems development costs that it incurred through the end of FY 1996 to the appropriate depot maintenance and supply management organizations, its FY 1996 financial statements were materially overstated. Until the JLSC is advised of the proper method of equitably allocating its systems development costs to the appropriate WCF organizations, its financial statements will continue to be overstated, and the financial statements of those organizations that received the assets (that is, systems developments) will continue to be understated. Moreover, unless JLSC systems developments are exempt from the USD(C) policy for recovery of depreciation costs and depreciation is recorded as unfunded costs, customers of the WCF organizations that received the JLSC systems developments will have to pay nearly \$2 billion in development costs again. Customer charges or rates have already been established for FY 1999. Recovering the depreciation costs of systems developments would result in unnecessary costs to customers of the depot maintenance and supply management business areas during FYs 2000 through 2004.

Recommendations and Management Comments

We recommend that the Under Secretary of Defense (Comptroller):

1. Provide guidance to the Joint Logistics Systems Center on how to equitably allocate its systems development costs to the appropriate Working Capital Fund organizations and direct that those organizations properly capitalize and report in their financial statements the costs incurred by the Joint Logistics Systems Center for systems developments, as required by DoD 7000.14-R, the "DoD Financial Management Regulation," volume 11B, "Reimbursable Operations, Policy and Procedures -- Defense Business Operations Fund," December 1994.

2. Exempt the Joint Logistics Systems Center's systems developments from the policy for recovery of depreciation costs in the Working Capital Funds because those developments were paid for previously. Instead, direct that depreciation of Joint Logistics Systems Center systems developments be recorded on accounting records in an unfunded depreciation account.

USD(C) Comments Requested. The USD(C) did not comment on a draft of this report. Therefore, we request that he provide comments on the final report.

Transfer of Costs and Recovery of Depreciation for Systems Developments

JLSC Comments. The Commander, JLSC, provided unsolicited comments on the draft report. He concurred with the finding and stated that he believed the report was factually correct. He emphasized that JLSC could not properly transfer the costs of developments or completed systems to the receiving organizations for capitalization because guidance from the Under Secretary of Defense (Comptroller) was lacking. See Part III for the text of the JLSC comments.

Part II - Additional Information

Appendix A. Audit Process

Scope and Methodology

The scope of this audit was limited to the JLSC property, plant, and equipment (capital asset) accounts. Specifically, we reviewed the validity of the \$1.3 billion reported by the JLSC for property, plant, and equipment on its FY 1996 financial statements. To accomplish the audit, we obtained the accounting records used to report the values of property, plant, and equipment. We also requested, and JLSC managers provided, cost data on system developments as of September 30, 1996. Additionally, we reviewed WCF program budget decision data that established JLSC systems development funding for FYs 1992 through 1999. We also reviewed USD(C) financial policies for the WCFs on the capitalization, depreciation, and financial statement reporting of property, plant, and equipment issued from September 1991 through August 1997. With senior managers in the Office of the USD(C) and JLSC, we discussed the equitable transfer of JLSC development costs to WCF depot maintenance and supply management business areas and the appropriateness of the recovery of depreciation costs for JLSC systems developments.

Audit Type, Dates, and Standards. This financial-related audit was conducted from April through August 1997 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We did not use computer-processed data or statistical sampling procedures.

Contacts During the Audit. We visited or contacted individuals or organizations within the DoD. Further details are available upon request.

Management Control Program

The management control program will be reviewed during our planned audit of the JLSC FY 1997 financial statements.

Summary of Prior Coverage

IG, DoD, Report No. 94-147. This report, "Joint Logistics Systems Center's Financial Statements for FY 1993," was issued on June 24, 1994. The auditors disclaimed an opinion on the FY 1993 financial statements because the accounting system in place, as recognized by the JLSC in its management representation letter, did not provide the information needed to prepare the financial statements. Additionally, the JLSC had not established controls to provide reasonable assurance that material misstatements in financial records and statements would be prevented.

We recommended that the JLSC establish a management control program; capitalize all applicable capital assets and disclose the extent of no-cost usage for facilities and services; discontinue the use of operating budget funds on capital projects; and establish effective year-end closeout procedures to ensure that all project expenditures are accurately reflected in the financial statements. The JLSC generally concurred with the recommendations and stated that they were working with the Defense Finance and Accounting Service to correct the reported deficiencies.

Appendix B. Summary of Potential Benefits

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
1.	Compliance with laws and regulations. As required by the DoD 7000.14-R, the "DoD Financial Management Regulation," volume 11B, "Reimbursable Operations, Policy and Procedures -- Defense Business Operations Fund," December 1994, the JLSC should transfer development costs to the appropriate WCF organization for capitalization and financial reporting.	Nonmonetary.
2.	Economy and efficiency. Eliminates the requirement for WCF organizations to charge their customers again, through the recovery of depreciation, for the costs of JLSC developments.	Funds put to better use. Eliminating the requirement to recover the \$1.998 billion spent on JLSC systems developments through depreciation would reduce the Operation and Maintenance Appropriations needed by military operational units for FYs 2000 through 2004 to pay for goods and services received from WCF depot maintenance and supply management business areas (see Summary, page 9).

Appendix C. Report Distribution

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Part III - Management Comments

Joint Logistics Systems Command Comments



JOINT LOGISTICS SYSTEMS CENTER

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REC 04 1997

MEMORANDUM FOR INSPECTOR GENERAL DEPARTMENT OF DEFENSE
ATTN: MR. JAMES L. KORNIDES, AUDIT PROGRAM DIRECTOR
400 ARMY NAVY DRIVE
ARLINGTON VA 22202-2884

FROM: JLSC/cc

SUBJECT: Draft Audit Report on Joint Logistics Systems Center Reporting of Systems
Development Costs (Project No. 7FJ-2027)

1. The Joint Logistics Systems Center (JLSC) concurs with all findings of subject report and believes it is factually correct. However, we request that two comments made in the report be changed to preclude possible inference that there may be fault with JLSC, which is not true.
2. First, Executive Summary, Part I-Audit Results, page 5, Transfer of Development Cost: The sentence currently reads: "However, when the systems were delivered and installed at various Working Capital Funds (WCF) organizations, the JLSC did not properly transfer the costs of developments to the receiving organizations for capitalization." The sentence should read: "However, when the systems were delivered and installed at various WCF organizations, the JLSC could not properly transfer the costs of developments to the receiving organizations for capitalization, due to lack of guidance from Under Secretary of Defense (Comptroller)." Secondly, Part I-Audit Results, page 7, Effect on Financial Statements should be changed. It currently reads: "Because JLSC did not transfer the costs of completed systems developments to the WCF organizations that were operating the systems, the FY 1996 financial statements were materially overstated." Please have it to read: "The JLSC could not transfer the costs of completed systems developments to the WCF organizations that were operating the systems due to lack of guidance. Consequently, the FY 1996 JLSC financial statements were materially overstated."
3. Our point of contact is Mr. Dennis Kahn, JLSC/RMF, DSN 785-0407, (937) 255-0407.


DAVID A. HERRELKO
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