

Audit

Report



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INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND
REGULATIONS FOR THE FY 1999 FINANCIAL STATEMENTS FOR
OTHER DEFENSE ORGANIZATIONS-GENERAL FUNDS

Report No. D-2000-103

March 16, 2000

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Department of Defense

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Acronyms

| | |
|---------|----------------------------------------------|
| CFO | Chief Financial Officers |
| DFAS | Defense Finance and Accounting Service |
| FFMIA | Federal Financial Management Improvement Act |
| IG | Inspector General |
| OMB | Office of Management and Budget |
| USGSGGL | U.S. Government Standard General Ledger |



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

March 16, 2000

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and
Regulations for the FY 1999 Financial Statements for Other Defense
Organizations-General Funds (Report No. D-2000-103)

We are providing this report for your information and use. We conducted this
audit in response to the Chief Financial Officers Act of 1990, as amended by the
Federal Financial Management Act of 1994.

No written response to this report was required and none was received.
Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the audit staff. For additional
information on this report, please contact 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 E for the
report distribution. The audit team members are listed inside the back cover.

A handwritten signature in black ink, 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. D-2000-103
(Project No. 0FA-2108)

March 16, 2000

Internal Controls and Compliance With Laws and Regulations for the FY 1999 Financial Statements for Other Defense Organizations- General Funds

Executive Summary

Introduction. 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 DoD and other Government agencies to prepare annual audited financial statements. The FY 1999 DoD Agency-wide financial statements include financial statements for a reporting entity entitled "Other Defense Organizations-General Funds." The entity represents a consolidation of financial information from various Defense organizations and funds that use the Treasury Index 97 symbol, also referred to as Department 97. (See Appendix B for a listing of Other Defense Organizations-General Funds). Other Defense Organizations-General Funds reported \$53.1 billion in budget authority in the FY 1999 financial statements. Reports on Budget Execution are the major financial reports supporting the Statement of Budgetary Resources and portions of other financial statements prepared as a result of the Chief Financial Officers Act of 1990.

Objective. The overall audit objective was to assess internal controls and compliance with laws and regulations used for accounting, reporting, and compiling financial data to support the FY 1999 financial statements of Other Defense Organizations-General Funds. In a future report, we will report on the adequacy of the procedures used to compile and make adjustments to the FY 1999 financial statements of Other Defense Organizations.

Review of Internal Controls. Controls used to compile departmental Reports on Budget Execution did not provide reasonable assurance that the reports were accurate and reliable. The Defense Finance and Accounting Service Indianapolis Center did not adequately explain \$2.3 billion of the reported \$3 billion in abnormal balances and made unsupported budgetary adjustments of \$13.4 billion to force accounting records to match U.S. Treasury records. The \$13.4 billion included adjustments of \$0.9 billion to collections, \$3.3 billion in disbursements, \$5.8 billion to accounts payable, and \$3.4 billion to accounts receivable. Additionally, the Defense Finance and Accounting Service Indianapolis Center arbitrarily offset \$286 million of undistributed accounts payable for appropriations canceling in FY 1999 against existing balances in other closing accounts.

Controls over the process used to consolidate and compile the financial statements for the Other Defense Organizations did not provide reasonable assurance that the financial statements for Other Defense Organizations were accurate and reliable. The Trial Balance Tracking System, used to determine whether all required trial balances had been received, excluded at least 179 appropriations and subordinate allocations; 12 of the 15 accounting offices supporting the Other Defense Organizations submitted trial balances after the November 1 deadline; portions of trial balances were created from Reports on Budget Execution rather than general ledger records; the compilation process expanded from three stages to six, adding risk to the process; and the Defense Finance and Accounting Service Indianapolis Center made at least

Controls over the process used to consolidate and compile the financial statements for the Other Defense Organizations did not provide reasonable assurance that the financial statements for Other Defense Organizations were accurate and reliable. The Trial Balance Tracking System, used to determine whether all required trial balances had been received, excluded at least 179 appropriations and subordinate allocations; 12 of the 15 accounting offices supporting the Other Defense Organizations submitted trial balances after the November 1 deadline; portions of trial balances were created from Reports on Budget Execution rather than general ledger records; the compilation process expanded from three stages to six, adding risk to the process; and the Defense Finance and Accounting Service Indianapolis Center made at least \$105.2 billion of unsupported adjustments to force the general ledger trial balances to agree with Reports on Budget Execution. In addition, controls over financial reporting by supporting accounting offices for obligations and charges to foreign military sales were not adequate to ensure that financial data supplied to the Defense Finance and Accounting Service Indianapolis Center were accurate and reliable.

Review of Compliance With Laws and Regulations. We identified instances of noncompliance with laws and regulations related to the Federal Financial Management Improvement Act of 1996; section 3512, title 31, United States Code; and the Chief Financial Officers Act of 1990. Our limited review of the compliance with laws and regulations did not necessarily disclose all instances of potential noncompliance with laws and regulations that may be considered material to the financial statements for the Other Defense Organizations-General Funds reporting entity.

Management Comments. We provided a draft of this report on February 7, 2000. No written response to this report was required and none was received. Therefore, we are publishing this report in final form.

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Introduction

Background

Reporting Requirements. Public Law 101-576, the “Chief Financial Officers Act of 1990,” November 15, 1990, as amended by Public Law 103-356, the “Federal Financial Management Act of 1994,” October 13, 1994, requires DoD to prepare annual audited financial statements. In addition, the Federal Financial Management Act of 1994 requires the Secretary of the Treasury, in coordination with the Director, Office of Management and Budget, to prepare Government-wide financial statements. The Inspector General (IG), DoD, is not required to render a separate opinion on the financial statements for Other Defense Organizations. However, information from audits of the financial statements of Other Defense Organizations contributed to the disclaimer of audit opinion on the DoD Agency-wide financial statements for FY 1999.

Other Defense Organizations. Other Defense Organizations represent a consolidation of financial information from various Defense organizations and funds that use the Treasury Index 97 symbol. The DoD Agency-wide consolidating financial statements include two columns for Other Defense Organizations: an Other Defense Organizations-Working Capital Funds column that includes the financial activity of working capital funds not connected with the Military Departments, and an Other Defense Organizations-General Funds column that includes the financial activity of all remaining organizations and funds using the Treasury Index 97 symbol. This audit focused on Other Defense Organizations-General Funds, which reported \$53.1 billion in budget authority in the FY 1999 financial statements. (Later references to Other Defense Organizations in this report will generally refer to the Other Defense Organizations-General Funds reporting entity.) Appendix B provides a list of Other Defense Organizations-General Funds.

Accounting Functions and Responsibilities. The Defense Finance and Accounting Service (DFAS) was established in January 1991 to perform accounting functions for DoD. During FY 1999, DFAS accounting offices provided accounting support for all Defense organizations that use Treasury Index 97 funds except for the following:

- certain organizations supported by the Washington Headquarters Services Allotment Accounting System,
- the Tricare Management Activity-West, and
- organizations required to perform their own accounting because of security considerations.

Compilation Responsibilities. DoD Regulation 7000.14-R, the “DoD Financial Management Regulation,” volume 6B, “Form and Content of the

Department of Defense Financial Statements,” chapter 2, “General Instructions for the Financial Statements,” October 1999, requires DFAS, in coordination with DoD Components, to prepare financial statements. Beginning in FY 1996, the DFAS Indianapolis Center, Indianapolis, Indiana, was responsible for preparing the financial statements for Treasury Index 97 funds. Other Defense Organizations use the same DoD form and content guidance as the Military Departments.

The Defense Agency Team at DFAS Indianapolis Center received budgetary information from accounting offices and prepared required Reports on Budget Execution for submission to the Under Secretary of Defense (Comptroller) and the Office of Management and Budget. The Defense Agency Team forwarded those Reports on Budget Execution to the “CFO [Chief Financial Officers] Team” at DFAS Indianapolis Center, which used that information and trial balances received from supporting accounting offices to prepare financial statements required by the CFO Act.

Objective

The overall audit objective was to assess internal controls and compliance with laws and regulations used for accounting, reporting, and compiling financial data to support the FY 1999 financial statements of Other Defense Organizations-General Funds.

In a future report, we will evaluate the procedures used to compile and make adjustments to the FY 1999 financial statements of Other Defense Organizations. Appendix A discusses audit scope, methodology, and prior coverage. Appendix B lists the DoD organizations and funds that comprise the Other Defense Organizations-General Funds. Appendix D lists the laws and regulations reviewed.

Review of Internal Controls

Overview of Material Weaknesses

Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal controls does not reduce to a relatively low level the risk that error or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited and would not be detected in a timely manner by employees in the normal course of performing their functions.

We performed applicable tests of the internal controls to determine whether the controls were effective and working as designed. We identified inadequate controls related to establishing standard operating procedures, increasing disclosure of adjustments and abnormal balances, establishing systems to obtain sufficient information to eliminate unsupported adjustments, testing compilation procedures and new processes used, and ensuring that reported obligations are reliable. Our consideration of internal controls would not necessarily disclose all reportable conditions and would not necessarily disclose all reportable conditions that are material weaknesses.

Internal Control Components

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, implement section 3512, title 31, United States Code, which requires management to establish and maintain a comprehensive management control system, including internal controls, and to monitor and report on the system. Statement on Auditing Standards No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55," defines internal controls as a process performed by management or other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Statement on Auditing Standards No. 78 states that the internal control structure consists of five interrelated components: the control environment, risk

assessment, control activities, information and communication, and monitoring. This report discusses our assessment of those interrelated internal control components.

Control Environment

The control environment includes factors that set the tone of an organization, influencing the control consciousness of its employees. The control environment includes several organizational factors, such as management's philosophy and commitment to competence. IG, DoD, audits have identified opportunities to improve the control environment by developing and improving standard operating procedures and increasing employees' knowledge of Federal financial practices through training.

Standard Operating Procedures. Our review of the Report on Budget Execution for the Defense Advanced Research Projects Agency for June 30, 1999, and supporting financial records and related trial balances showed material differences totaling \$876.9 million for obligations incurred, the balances forwarded, and undelivered orders.¹ Those differences occurred in part because the Defense Agency Financial Services accounting office² at DFAS Indianapolis Center did not have adequate written procedures to do the following:

- ensure that reports were visually reviewed for obvious errors and abnormalities;
- identify required year-end procedures and ensure that pen-and-ink changes were entered into the accounting systems during the subsequent year; and
- reconcile related reports, explain differences in footnotes, and resolve discrepancies.

Training. Accounting personnel in the Defense Agency Financial Services accounting office at DFAS Indianapolis Center did not demonstrate a knowledge of Federal financial accounting commensurate with the core competencies established by the Joint Financial Management Improvement Program. Training records for seven accountants from that accounting office showed that none of the accountants had received formal training in the preparation of budget execution reports, and only four had received training in the U.S. Government

¹Draft Report on "Accounting Procedures and Controls Over Financial Data Supporting Other Defense Organizations," Project No. 9FA-2018, November 30, 1999.

²The Defense Agency Financial Services accounting office performs accounting support for at least 18 Other Defense Organizations.

Standard General Ledger (USGSGL). When interviewed, personnel could not explain the impact on the general ledger of entering funding, obligations, or expenditures into the accounting systems used by the office.

Risk Assessment

For financial reporting purposes, an entity's risk assessment is its identification, analysis, and management of risks relevant to the preparation of financial statements. The DFAS Indianapolis Center's FY 1999 Annual Statement of Assurance identified the following categories of material control weaknesses, which have a high risk of contributing errors to the financial statements prepared for the Other Defense Organizations:

- trial balance reporting for Defense agencies,
- problem disbursements,
- reconciliation of balances in suspense accounts, and
- unreliable financial reporting of personal and real property.

The DFAS Indianapolis Center also considered the compilation process for the annual financial statements for Other Defense Organizations as a high-risk area and has worked to improve that process. At the end of FY 1999, DFAS added contractor support to assist in compiling the financial statements. The additional resources should help reduce some of the risk. However, DFAS Indianapolis Center also added additional review levels to the compilation process, which increased the risk of errors and material misstatements, because the new processes had not been fully tested before beginning the compilation process. A subsequent section of this report on the "CFO Compilation Process" and Appendix C provide additional discussion of the CFO compilation process.

Control Activities and Information and Communication

Control activities are the various policies and procedures that help ensure that the necessary actions are taken to address risks to achieve the entity's objectives. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to do the following:

- record, process, summarize, and report entity transactions and
- maintain accountability of the related assets and liabilities.

Communication involves providing an understanding of individual roles and responsibilities for internal control over financial reporting. To be effective, the information and communication system must identify and record all valid

transactions on a timely basis; properly measure the value of and record transactions in the proper time period; properly present and disclose transactions; and communicate responsibilities to employees.

Budgetary Reporting. Controls used to compile departmental Reports on Budget Execution, which are later used to compile the Statement of Budgetary Resources, did not provide reasonable assurance that the information on those reports was accurate and reliable. Because the CFO Team used the Reports on Budget Execution to prepare the Statement of Budgetary Resources, the reliability of the Reports on Budget Execution was essential. However, the Reports on Budget Execution were not reliable because the DFAS Indianapolis Center did not adequately footnote \$3.0 billion of abnormal balances and made at least \$13.4 billion of unsupported adjustments to force the report to match U.S. Treasury records. The CFO Team, using the Reports on Budget Execution in combination with trial balances, prepared the financial statements for the Other Defense Organizations.

Abnormal Balances on the Reports on Budget Execution. The Defense Agency Team at DFAS Indianapolis Center prepared Reports on Budget Execution for Other Defense Organizations, which contained \$3.0 billion of abnormal negative balances included on 9 different lines of the Report on Budget Execution. However, \$2.3 billion of the \$3.0 billion was not explained in the footnotes. For example:

- “Obligated Balance, Net as of October 1” (line 12) showed a combined abnormal balance of \$1.1 billion.
- “Accounts Payable” (line 14D) showed a combined abnormal balance of \$230.5 million.
- “Disbursements” (line 15A) showed a combined abnormal balance of \$196.6 million.

DFAS Indianapolis Center “Fiscal Year 1999 Year-End Instructions for Defense Agencies,” June 9, 1999, requires report preparers to “properly footnote, with a detailed explanation, all abnormal balances,” on the Reports on Budget Execution. The Defense Agency Team did not prepare complete footnotes for the abnormal balances because accounting officers did not provide reasons for the abnormal balances and the Defense Agency Team did not have time after receipt of budgetary information to obtain reasons from supporting accounting offices.

The Defense Agency Team forwarded the Reports on Budget Execution to the CFO Team at DFAS Indianapolis Center, and the CFO Team adjusted trial balance data to match the budgetary balances. That action caused abnormal

balances in the consolidated trial balance. The inadequacy of footnoting on the Reports on Budget Execution contributed to the CFO Team making unsupported adjustments to the trial balances.

Adjustments to Match U.S. Treasury Records. The DFAS Indianapolis Center made unsupported adjustments of \$3.3 billion to disbursements and \$0.9 billion to collections to force the Reports on Budget Execution to match U.S. Treasury records. Instead of reconciling the budgetary data received from accounting offices with the data received from disbursing stations as required by the Department of the Treasury,³ the DFAS Indianapolis Center merely adjusted the Reports on Budget Execution. When adjusting disbursements and collections, the Defense Agency Team concurrently made offsetting unsupported adjustments of \$3.4 billion to accounts receivable and \$5.8 billion to accounts payable. The adjustments were summary-level adjustments and were not entered into the official accounting records for the Other Defense Organizations.

Adjustments to Eliminate Accounts Receivable and Accounts Payable. For appropriations canceling in FY 1999, the Defense Agency Team subtracted \$22 million of undistributed⁴ accounts receivable from \$308 million of undistributed accounts payable to eliminate undistributed accounts receivable. The balance of \$286 million in undistributed accounts payable was moved from the undistributed account and arbitrarily offset against existing balances in other closing accounts because transactions creating accounts receivable and accounts payable were not recorded in the accounting records before the appropriations were canceled.

Actions Taken to Reduce the Unsupported Adjustments. During FY 1999, DFAS Indianapolis Center prepared the "Treasury Index 97 Cash Controls and Accountability Concept of Operations," which was designed to fully account for Treasury Index 97 cash balances, provide accounting offices with the necessary information to fully account for their portion of the undistributed cash balances, and eliminate the need to make large unsupported adjustments to force accounting records to match U.S. Treasury records. As of December 1999, DFAS Indianapolis Center had retained a contractor to develop the necessary programs and anticipated using the new programs during the second quarter of FY 2000.

CFO Consolidation Process. The CFO Team attempted to improve the process used for consolidating Treasury Index 97 financial data; however, the process taken as a whole did not have adequate controls to ensure that financial data were complete and accurate. The CFO Team needed to update the Trial Balance Tracking System, accounting offices continued to submit trial balances after the deadline, and the CFO Team needed to manually create trial balances.

³Treasury Financial Manual, volume 1, part 2, chapter 5100, "Reconciling Fund Balance With Treasury Accounts," October 1999, requires Federal agencies to reconcile the Fund Balance With Treasury account in the general ledger to the disbursing data prepared from disbursing stations.

⁴The difference between the amounts of disbursements and collections reported to the U.S. Treasury from disbursing stations and the amounts reported by the accounting offices to DFAS is considered "undistributed" amounts. Undistributed disbursements are further divided into unmatched disbursements, which are payments that cannot be matched to a specific obligation, and in-transit disbursements, which are disbursements for which payment information has not yet been received by the accounting office.

Trial Balance Tracking System. To comply with prior IG, DoD, recommendations,⁵ the CFO Team established a system during FY 1999 for tracking quarterly trial balances submitted by the accounting offices supporting Other Defense Organizations. The CFO Team designed a spread-sheet-based tool, the Trial Balance Tracking System, which identified the Other Defense Organizations, points of contact for the supporting accounting offices, the basic symbol and limit,⁶ and a column for each quarter, to confirm whether the CFO Team received trial balances.

The Trial Balance Tracking System excluded at least 179 basic symbols and limits (appropriations and subordinate allocations) for which trial balances were needed because the CFO Team improperly relied on Army guidance⁷ for the Treasury Index 97 consolidation process instead of using DFAS-Indianapolis Center Manual 7097.01, "Financial Management Departmental Reporting Manual for Office of the Secretary of Defense (Treasury Index 97) Appropriations," September 1999. The DFAS-Indianapolis Center Manual 7097.01 included additional limits, which if used, would have improved the completeness and reliability of the tracking system. The system also was not current because the CFO Team did not compare the basic symbols and limits in the Trial Balance Tracking System with the basic symbol and limits for which Reports on Budget Execution were prepared. Performing that validation would have helped ensure that CFO reporting was consistent with budgetary reporting.

As part of our control test, we performed that validation and determined that 179 basic symbols and limit combinations should have been added to the Trial Balance Tracking System. For example, 21 basic symbol and limit combinations for the Defense Information Systems Agency were omitted from the Trial Balance Tracking System. The CFO Team took action to update the tracking system and agreed to use the proper guidance for future CFO reporting. Therefore, we are not making any recommendations in this report.

Timeliness of Trial Balance Submissions. Accounting offices supporting the Other Defense Organizations submitted trial balances to the DFAS Indianapolis Center after established due dates, and the number of delinquent accounting offices had not decreased during the last 2 years. Although required to submit trial balances to the CFO Team by November 1, 1999,⁸ 12 of the 15 accounting offices submitting trial balances to

⁵IG, DoD, Audit Report No. 99-006, "Consolidation Process for FY 1997 Financial Statements for Other Defense Organizations," October 6, 1998, recommended that DFAS Indianapolis Center establish a system for tracking trial balances submitted each quarter.

⁶Appropriation limits are the four-digit suffixes to the U.S. Treasury account number (basic symbol) that identify a subdivision of funds, restrict the amount or use of funds for a certain purpose, or identify sub-elements within the account for management purposes. For Other Defense Organizations, the appropriation limit usually shows the organization or fund for which the appropriation provides funding.

⁷DFAS-Indianapolis Center Manual 37-100, "Financial Management Implementation," July 1999, provides guidance for Army appropriations rather than for those of Other Defense Organizations.

⁸DFAS Indianapolis Center Memorandum "Fiscal Year-End Instruction for Defense Agencies," June 9, 1999, requires that all Other Defense Organizations submit their trial balances to the CFO Team by November 1, 1999, for consolidation.

the CFO Team did not meet the November 1 deadline. The CFO Team received the final trial balances on November 17. The CFO Team could not begin the compilation process until it received all trial balances.

Accounting offices made improvements during FY 1999 in submitting quarterly trial balances. Accounting offices submitted 5 trial balances in the first quarter, 27 in the second, 173 in the third, and 212 in the fourth. That trend shows dramatic improvement in the number of submissions received. Continued efforts by DFAS Indianapolis Center in working with accounting offices that do not submit required quarterly trial balances would help DFAS Indianapolis Center to identify errors and resolve problems before the FY 2000 year-end compilation process. We will continue to review the progress in submission of quarterly trial balances and resolution of problems associated with those trial balances in future audits.

Manually Created Trial Balances. As part of the consolidation process for FY 1999, the CFO Team manually created trial balances for seven reporting entities included in Other Defense Organizations using data from the Reports on Budget Execution instead of from general ledger accounts. Reports on Budget Execution do not contain financial data for the entire scope of an entity's operations such as accrued annual leave expenses; property, plant, and equipment; and related depreciation, and therefore, were incomplete. The combined balances from those seven reporting entities were material to both the financial statements of the Other Defense Organizations and the Defense Agency-wide financial statements. For example, when combined, the Fund Balance With Treasury for all seven entities totaled \$4.4 billion.

CFO Compilation Process. The DFAS Indianapolis Center reduced the time required to provide financial statements to the IG, DoD, for audit. However, DFAS Indianapolis Center expanded the compilation process from three to six stages, which increased the risk that financial data supplied by the accounting offices supporting the Other Defense Organizations would not be accurately compiled into the financial statements for the Other Defense Organizations. The CFO Team also made at least \$105.2 billion of unsupported adjustments to force the trial balances to match budgetary data.

Expansion of Compilation Stages. Internal control risk for the FY 1999 CFO compilation process increased because DFAS Indianapolis Center expanded the compilation process from three to six stages, which required additional crosswalks, queries, and software applications. (See Appendix C for further discussion.) We support the DFAS decision to allocate additional resources to improve the compilation process. The additional resources include contractor support in preparing a system needed to produce automated financial statements. However, the procedures and crosswalks had not been fully mapped and tested before the compilation process began. The lack of mapping and testing created numerous problems as shown in this section of the report, and we were unable to test the controls for the new process before its execution.

The compilation process for the FY 1999 financial statements used two general ledgers, used at least four software packages, required additional crosswalks and edit tables, and added numerous queries. Crosswalks, edit tables, and queries are created to transfer and manipulate financial records, and they have an inherent risk for potential error until fully tested. However, the

DFAS Indianapolis Center did not test the compilation system before the end of FY 1999, as we recommended in the audit report for the FY 1998 financial statements.⁹ The FY 1999 compilation system was not completed until the first week of November 1999, and the CFO Team encountered additional problems after completion, such as the following:

- account balances dropped when data were transferred to another level,
- multiple journal vouchers mixed together,
- data out of balance,
- required account attributes missing, and
- accounts in one level transferred to wrong accounts in a following level.

The CFO Team used valuable compilation time to correct the errors in the compilation system.

Adjustments to Force Trial Balances to Match Budgetary Records.

The CFO Team adjusted the consolidated trial balances by \$105.2 billion to force the general ledger trial balances to agree with the Reports on Budget Execution. We will analyze and discuss those adjustments in a later compilation report. The data between those reports should have been similar¹⁰ and the differences reconciled and explained as required by DoD Regulation 7000.14-R;¹¹ however, DFAS Indianapolis Center did not perform a reconciliation nor explain the differences.

Quality of Financial Data Supplied to DFAS Indianapolis Center. The poor quality of financial data provided to the CFO Team at the DFAS Indianapolis Center continued to impact the quality and reliability of the financial statements prepared for the Other Defense Organizations. For example, outpatient visits data, unliquidated obligations, and reported disbursements were not reliable.

Military Retirement Health Benefits Liability. The Composite Health Care System outpatient visits data were unreliable for use in developing the FY 1998 Military Retirement Health Benefits Liability estimate. Outpatient medical care services represented \$100 billion of the reported FY 1998 unfunded liability of \$223 billion. The Assistant Secretary of Defense (Health Affairs) agreed that the data were unreliable and took action to improve the

⁹IG, DoD, Audit Report No. 99-139, "Internal Controls and Compliance With Laws and Regulations for the FY 1998 Financial Statements of Other Defense Organizations," April 21, 1999, recommended that DFAS Indianapolis Center test the financial system before the end of FY 1999.

¹⁰DoD Regulation 7000.14-R, Volume 6, "Reporting Policy and Procedures," chapter 2, requires DFAS to validate that "reported amounts for the same data elements for the same report period are consistent across all similar financial reports."

¹¹DoD Regulation 7000.14-R, Volume 6, "Reporting Policy and Procedures," chapter 2, directs DFAS to ensure that "all general ledger balances and other associated financial balances which require supporting subsidiary records are reconciled... ."

quality of data in time to impact the FY 2001 liability estimate. Therefore, the FY 1999 estimate was also based on unreliable data. In addition to outpatient visit data, the DoD information used to determine the cost of medical care is being reviewed by a DoD working group, which is developing more complete cost information for use in developing the estimate.

Unliquidated Obligations. FY 1999 accounting records showing at least \$3.8 billion in unliquidated obligations for the Ballistic Missile Defense Organization, the Defense Advanced Research Projects Agency, the Joint Staff, and Washington Headquarters Services were inaccurate and unreliable.¹² The condition occurred because DFAS disbursing and accounting personnel did not correctly record disbursements, and the Other Defense Organizations did not complete reviews to validate unliquidated obligations. Unless corrected, the amount reported for Obligations, Net End of Period on the FY 1999 Statement of Budgetary Resources for the Defense Agency-wide financial statements will contain material amounts that are not reliable.

Timeliness of Recording Obligations. The Ballistic Missile Defense Organization, the Defense Advanced Research Projects Agency, the Joint Staff, and Washington Headquarters Services needed to improve the processes to record obligations in the official accounting records in a timely manner.¹³ A review of \$909 million in reported obligations for those organizations showed that \$354 million were not entered into the accounting records. Obligations were not promptly recorded in accounting records because those organizations did not have adequate controls in place to ensure that executing agents promptly provided obligating documents for input into accounting records. Delays in recording obligations can cause reported obligations to be reported during the wrong fiscal year.

Navy Charges to Foreign Military Sales Customers Trust Fund Accounts. The amount reported for disbursements on the Statement of Custodial Activity was at risk of being materially unreliable because the Navy did not record at least \$589 million of charges in a timely manner, did not charge foreign military sales customers trust fund accounts for the correct amounts, and did not ensure that the accounting system accurately reflected charges.¹⁴ The Navy took actions to correctly process \$365 million of those charges before the end of FY 1999. However, the weak internal controls of the Navy over accounting charges made to foreign military sales customers trust fund accounts increased the risk that the amount reported on the FY 1999 Statement of Custodial Activity as "Disbursed on Behalf of Foreign Governments and International Organizations" from those accounts was unreliable.

¹²IG, DOD, Report No. D-2000-097, "Accounting Procedures and Controls Over Financial Data Supporting Selected Other Defense Organizations," March 9, 2000.

¹³Our review of the timeliness of recording obligations for Other Defense Organizations during 1999 included only portions of the four organizations and two additional organizations: the Tricare Management Agency-West and the National Security Agency, which were able to promptly record obligations as required. We did not test controls over promptly recording obligations at the remaining Other Defense Organizations shown in Appendix B.

¹⁴General Accounting Office Report No. AIMD-99-213, "Foreign Military Sales, Navy's Accounting for Sales to Foreign Customers Needs Improvement," August 1999.

Monitoring

Monitoring assesses the quality of internal control performance over time and involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Monitoring activities are accomplished through ongoing activities, separate evaluations, or a combination of the two.

In June 1999, DFAS Indianapolis Center implemented a process for monitoring and tracking financial reporting deficiencies and corrective actions taken by establishing a Project Assessment Team. The Project Assessment Team prepared a tracking document known as the "DFAS Indianapolis Center Implementation Strategies for Other Defense Organizations General Fund." The team included representatives from each working group within DFAS Indianapolis Center responsible for initiating corrective actions. As of December 1999, the Project Assessment Team was working on several problems, which the IG, DoD, previously reported, related to the consolidation and compilation process for Other Defense Organizations. The problems and deficiencies included the need to do the following:

- document supporting adjustments to force accounting records to match U.S. Treasury records and force budgetary records to match trial balances that accounting offices submitted for Other Defense Organizations;
- map the process and systems for the consolidation and compilation process;
- work with accounting offices to obtain timely, complete, and accurate trial balances;
- compute and perform intra-fund eliminations; and
- provide additional staff to the preparation of the financial statements for the Other Defense Organizations.

The Project Assessment Team held monthly meetings to discuss progress and track the status of each action item. The implementation strategies identified each action item, planned and actual start and finish dates, the responsible working group, and a reference to the audit that identified the need for the action item. The work done by the Project Assessment Team has improved the ability of DFAS Indianapolis Center to monitor the status of efforts to correct problems and implement other strategies identified by higher headquarters to improve financial controls and reporting.

Review of Compliance With Laws and Regulations

Reportable Noncompliance

Reportable instances of noncompliance are failures to follow requirements, laws, or regulations that cause us to conclude that the aggregation of the misstatements resulting from those problems is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant.

Our objective was to assess the compliance with laws and regulations related to the FY 1999 financial statements for Other Defense Organizations, and not to express an opinion. However, our review of DFAS Indianapolis Center identified noncompliance issues related to the Federal Financial Management Improvement Act of 1996 (FFMIA); section 65, title 31, United States Code; and the Chief Financial Officers Act of 1990. Our limited review of the compliance with laws and regulations did not necessarily disclose all instances of potential noncompliance with laws and regulations that may be considered material to the financial statements for the Other Defense Organizations-General Funds reporting entity. (Appendix D shows laws and regulations reviewed.)

Federal Financial Management Improvement Act of 1996

The FFMIA requires us to report whether the agency's financial management systems substantially comply with Federal financial management system requirements, Federal accounting standards, and the USGSGSL at the transaction level.

Federal Financial Management System Requirements. Federal financial management system requirements were established in Office of Management and Budget (OMB) Circular No. A-127, "Financial Management Systems," July 23, 1993, which requires financial management systems to provide complete, reliable, consistent, timely, and useful information. The Joint Financial Management Improvement Program has published a series of Federal Financial Management System Requirements that establishes standard requirements for Federal agencies' integrated financial management systems.

Adjustments to Eliminate Undistributed Balances. The adjustments to eliminate undistributed accounts receivable and accounts payable did not comply with Federal Financial Management System Requirement No. 1, "Core Financial System Requirements," September 1995, which states that "all transactions to record financial events must post either individually or in summary, to the general ledger, regardless of the origin of the transaction."

The unsupported adjustments were not in compliance because transactions were not posted to the general ledger accounts of the Other Defense Organizations to which they should have been distributed.

Compilation System. The FFMIA requires each agency to implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the USGSGL at the transaction level. DFAS Indianapolis Center did not employ an integrated financial management system for departmental financial reporting. For example, DFAS Indianapolis Center uses the Program Budget Accounting System to account for funding, the "TI [Treasury Index] 97 Application" to prepare Reports on Budget Execution, miscellaneous systems to report on expenditures, and an entirely separate set of systems for compilation.

General Accounting and Finance System. During FY 1999, DFAS used the General Accounting and Finance System to account for \$5.3 billion of obligations and \$5.9 billion of disbursements of Treasury Index 97 funds allotted to the Air Force. General controls over the General Accounting and Finance System were not adequate to provide reasonable assurance that program and data files were protected from unauthorized access and modification.¹⁵ Because the general controls were determined to be inadequate, we did not review application controls. Therefore, amounts included on line 7, "Obligations Incurred" and line 16, "Total Outlays," on the Statement of Budgetary Resources were at a high risk of being unreliable. Although we did not perform substantive tests to evaluate the reliability of obligations and disbursements recorded in the system, we highlight the risks associated with Treasury Index 97 funds accounted for in the General Accounting and Finance System and the potential impact on financial statements for Other Defense Organizations.

Disbursing and Accounting Systems. The lack of a system integrating the disbursing and accounting functions prevented the DFAS accounting offices from promptly recording receivables and payables in the accounting records. Therefore, the financial system and related controls are not in compliance with FFMIA.

Federal Accounting Standards. Federal agencies reporting under the Government Management Reform Act of 1994 are required to follow the Statements of Federal Financial Accounting Standards agreed to by the Director, OMB; the Comptroller General of the United States; and the Secretary of the Treasury. Statement of Federal Financial Accounting Concept No. 1, chapter 7, "How Accounting Supports Federal Financial Reporting," states that the "accounting process begins with recording information about transactions between the government (or one of its component entities) and other entities." The adjustment for undistributed accounts receivable and accounts payable were not in compliance with Concept No. 1 because they were not supported by transactions in the general ledger.

U.S. Government Standard General Ledger (USGSGL). The Office of Management and Budget requires Federal agencies to implement the USGSGL

¹⁵IG, DoD, Report No. 99-233, "General Controls for the General Accounting and Finance System," August 17, 1999.

in their financial systems at the transaction level. Federal agencies are permitted to supplement their application of the USGSGL to meet agency-specific information requirements. However, agency standard general ledgers must maintain consistency with the USGSGL. As shown previously in this report, material portions of the financial statements, including \$4.4 billion in Fund Balance With Treasury prepared for Other Defense Organizations, were prepared from Reports on Budget Execution, rather than from standard general ledgers. Further, because the financial systems used to report on budgetary resources were not integrated, the Reports on Budget Execution included summary-level adjustments that were not supported by detailed transactions recorded in the general ledgers of the accounting offices supporting Other Defense Organizations.

Section 65, Title 31, United States Code

The evaluation and reporting requirements of the Federal Managers' Financial Integrity Act of 1982 for an agency's internal accounting and administrative control systems were incorporated in section 65, title 31, United States Code (31 U.S.C. 65). That section requires DoD to evaluate the systems and to annually report whether those systems are in compliance with 31 U.S.C. 65. In FY 1999, DFAS reported material internal control weaknesses involving noncompliance with accounting principles, standards, and other requirements. The following reported material weaknesses related to the financial statements for Other Defense Organizations.

DFAS FY 1999 Annual Statement of Assurance. DFAS reported 38 uncorrected material weaknesses in its FY 1999 Annual Statement of Assurance. Of the 38 weaknesses, 12 directly affected the accounting data that DFAS Indianapolis Center used to prepare the FY 1999 financial statements of Other Defense Organizations and the FY 1999 DoD Agency-wide financial statements. The weaknesses, according to the DFAS FY 1999 Annual Statement of Assurance, included the following topics:

- general ledger control and financial reporting,
- expenditure authority approval before foreign military sales disbursements,
- fund balances with treasury,
- untimely contract fund reconciliation process,
- reconciliation of suspense account balances,
- inadequate check issue reconciliation,
- interface between contract payment system and accounting systems,
- inadequate general ledger control and unreliable financial reporting,

-
- undistributed and unmatched cross-disbursing and interfund transactions,
 - general ledger control and reconciliation,
 - trial balance reporting for Defense organizations, and
 - problem disbursements.

Chief Financial Officers Act of 1990

The CFO Act of 1990, as amended by the Federal Financial Management Act of 1994, requires DoD to prepare audited financial statements and to submit them to OMB no later than March 1, 2000. In the DoD Financial Management Improvement Plan, September 1999, DoD management acknowledged that major financial reporting deficiencies contributed to DoD not receiving an audit opinion and presented implementation strategies focused on correcting deficiencies in the following areas:

- inventory;
- property, plant, and equipment;
- future liabilities;
- U.S. Treasury fund balances; and
- intragovernmental eliminations.

DoD acknowledged that many accounting systems and feeder systems¹⁶ were not compliant with established regulatory requirements or had not been reviewed. Until DoD corrects ongoing deficiencies and develops fully compliant systems, financial reporting for the Other Defense Organizations will contribute to the Defense Agency-wide financial statements not receiving a favorable audit opinion.

¹⁶Program feeder systems are automated or manual systems operated by the Military Departments and the Defense agencies that contain day-to-day operating information requiring translation into financial information and processed in the finance and accounting systems.

Appendix A. Audit Process

Scope

Financial Information, Procedures, and Controls Reviewed. We are not expressing an opinion on the FY 1999 financial statements for Other Defense Organizations. Our audit was designed to support the FY 1999 DoD Agency-wide financial statements, and we focused on Other Defense Organizations-General Funds. We did not review supporting financial data and reports for Other Defense Organizations-Working Capital Funds. We reviewed the Reports on Budget Execution, and we specifically looked at abnormal balances, adjustments to force the Reports on Budget Execution to match U.S. Treasury records, and adjustments for canceling appropriations and undistributed accounts receivable and payable. We also reviewed data supporting the balance sheet, the Statement of Net Cost, the Statement of Budgetary Resources, the Statement of Financing, and the Statement of Custodial Activity. We reviewed the procedures and controls to accumulate financial data; to make adjustments; to produce appropriation-level reports submitted to the Office of Management and Budget (OMB), the Under Secretary of Defense (Comptroller), and DFAS; and to prepare the financial statements. We also reviewed the FY 1999 DoD Financial Management Improvement Plan, the DFAS headquarters and DFAS Indianapolis Center FY 1999 Annual Statements of Assurance, and prior audit reports. In a later audit, we plan to evaluate specific procedures that DFAS used to compile and report on the FY 1999 financial statements for Other Defense Organizations.

Accounting Principles. Accounting principles and standards for the Federal Government have been issued and are undergoing further development and refinement. The Federal Accounting Standards Advisory Board was established by Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States. On October 19, 1999, the American Institute of Certified Public Accountants recognized the Federal Accounting Standards Advisory Board as the body to establish generally accepted accounting principles for Federal governmental entities. Therefore, Statements of Federal Financial Accounting Standards issued by the Federal Accounting Standards Advisory Board are recognized as generally accepted accounting principles for applicable Federal governmental entities.

Agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended on November 20, 1998. The hierarchy is as follows:

- standards agreed to and published by the Director, OMB; the Secretary of Treasury; and the Comptroller General of the United States;
- interpretations of the Statements of Federal Financial Accounting Standards issued by OMB;

-
- requirements for the form and content of financial statements outlined in OMB Bulletin No. 97-01; and
 - accounting principles published by other authoritative sources.

DoD-Wide Corporate-Level Government Performance and Results Act (GPRA) Coverage. In response to the GPRA, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goal, and performance measures:

- **FY 2001 Corporate-Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-2)**
- **FY 2001 Subordinate Performance Goal 2.5:** Improve DoD financial and information management. **(01-DoD-2.5)**
- **FY 2001 Performance Measure 2.5.1:** Reduce the number of noncompliant accounting and financial systems. **(01-DoD-2.5.1)**
- **FY 2001 Performance Measure 2.5.2:** Achieve unqualified opinions on financial statements. **(01-DoD-2.5.2)**

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 objectives and goals.

Financial Management Functional Area. Objective: Strengthen internal controls. **Goal:** Improve compliance with the 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 DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

Auditing Standards. This audit was performed in accordance with auditing standards issued by the Comptroller General of the United States and OMB, as implemented by the IG, DoD, based on the objectives of the audit and the limitations to the scope described in the report. Accordingly, we included such tests of internal controls as we considered necessary.

Computer-Processed Data. We used computer-processed data in this audit; however, we did not confirm the reliability of the data because the accounting systems used to prepare the financial statements for Other Defense Organizations had serious limitations. The lack of reliable financial information was described as a material management control deficiency in the DoD Annual Statements of Assurance for FYs 1997 and 1998. The lack of reliable information did not adversely affect our analysis.

Audit Period and Location. We performed this financial-related audit from October 1999 through January 2000 at DFAS Indianapolis Center.

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

Prior Coverage

The General Accounting Office and the IG, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. IG, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil>.

Appendix B. Other Defense Organizations- General Funds

(includes trust funds and revolving funds not included in Treasury basic symbol "4930")

American Forces Information Service
Ballistic Missile Defense Organization
Defense Acquisition University
Defense Advanced Research Projects Agency
Defense Building Maintenance Fund
Defense Commissary Agency
Defense Contract Audit Agency
Defense Emergency Response Fund
Defense Finance and Accounting Service
Defense Health Program¹
Defense Homeowners Assistance Fund
Defense Information Systems Agency
Defense Intelligence Agency
Defense Legal Services Agency
Defense Logistics Agency
Defense Manpower Data Center Facility
Defense Prisoner of War/Missing Persons Office
Defense Security Cooperation Agency
Defense Security Service
Defense Threat Reduction Agency²
DoD Education Activity
DoD Education Benefits Fund
Federal Energy Management Fund
Foreign National Employees Separation Pay Account Trust Fund
Joint Chiefs of Staff
National Defense Stockpile Transaction Fund
National Imagery and Mapping Agency
National Security Agency
National Security Education Trust Fund
Office of Economic Adjustment
Office of the Inspector General
Office of the Secretary of Defense³
Pentagon Reservation Maintenance Revolving Fund
Ready Reserve Mobilization Income Insurance Fund
U.S. Court of Appeals for the Armed Forces
U.S. Special Operations Command
Voluntary Separation Incentive Trust Fund
Washington Headquarters Services

¹Includes the Tricare Management Activity, the Uniformed Services University of the Health Sciences, and funds allocated to Military Departments.

²Was formed on October 1, 1998, by consolidating the Defense Technology Security Administration, the Defense Special Weapons Agency, and the On-Site Inspection Agency.

³Includes other Treasury Index 97 funds provided to Military Departments and Defense organizations through the Office of the Secretary of Defense.

Appendix C. Comparison of the FYs 1998 and 1999 Compilation Process

For FY 1998, the CFO Team prepared the Defense agency master file to consolidate the trial balances and crosswalk those balances to the DFAS Indianapolis Center standard general ledger* (stage 1); prepared a "Source 97" file, which was used to adjust the consolidated trial balances to match budgetary data shown on Reports on Budget Execution (stage 2); and used the desktop application to crosswalk the consolidated trial balances to the U.S. Government Standard General Ledger and to prepare the financial statements (stage 3). See Figure C-1.

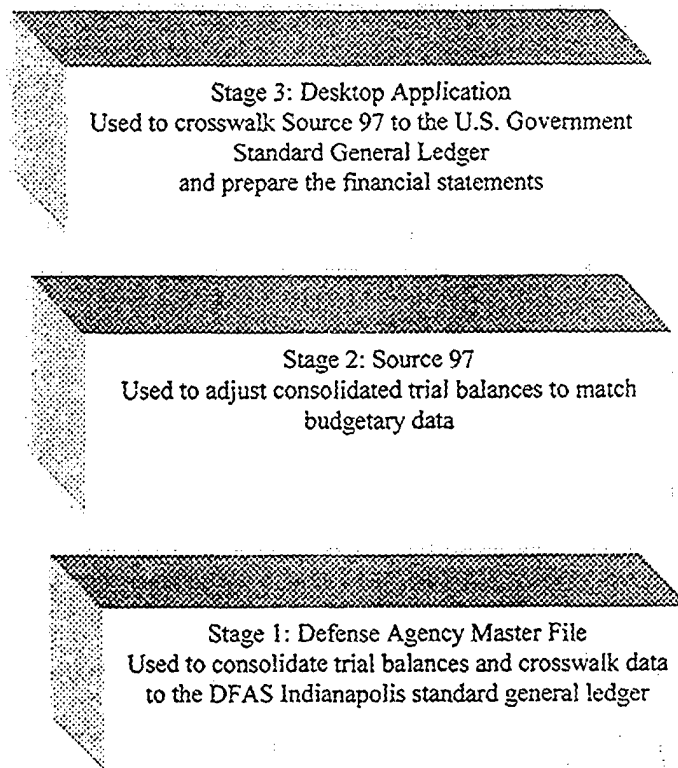


Figure C-1. Three Stages in the FY 1998 Compilation Process

For FY 1999, the CFO Team increased the control risk by adding three additional stages to the compilation process. The Federal Financial System was added to archive balances and adjustments made throughout the compilation process, and the CFO Financial System, a DFAS contractor-developed system, added stages 5 and 6. The input spreadsheets (stage 5) consolidated trial

*The DFAS Indianapolis Center standard general ledger is a previous version of the DoD Standard General Ledger.

balances from the desktop application and provided the universe of data for the queries at the final level. A database program (stage 6) queried the input spreadsheets and prepared the financial statements.

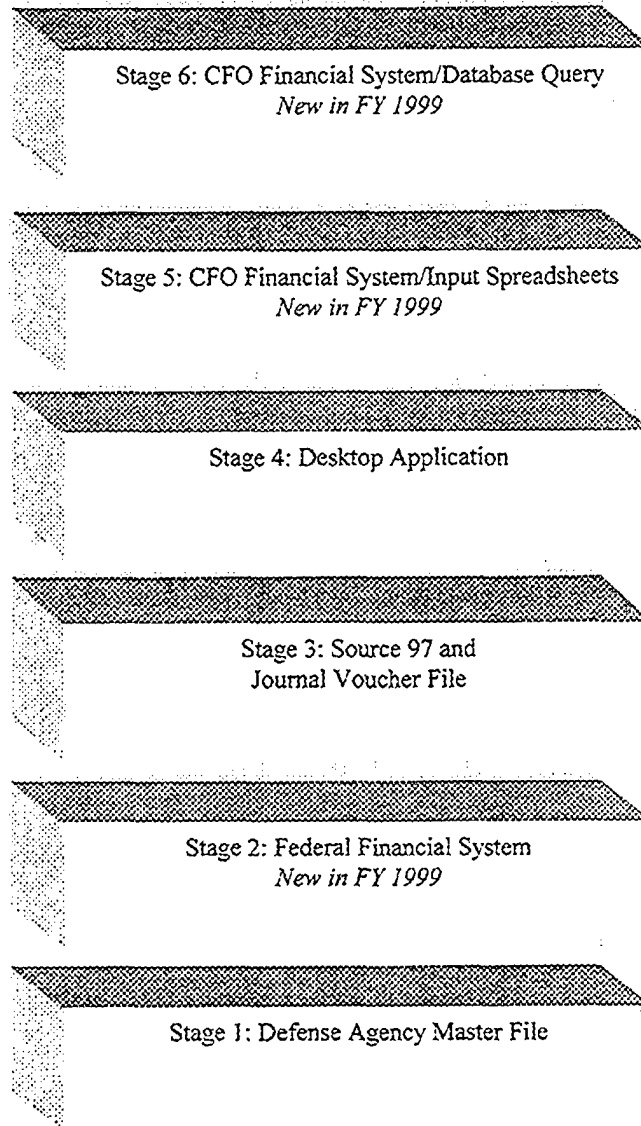


Figure C-2. Six Stages in the FY 1999 Compilation Process

Appendix D. Laws and Regulations Reviewed

Public Law 104-208, "Federal Financial Management Improvement Act of 1996," September 30, 1996 (section 3512, title 31, United States Code).

Public Law 103-356, "Federal Financial Management Act of 1994," October 13, 1994.

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990 (section 501, title 31, United States Code).

Public Law 97-255, "Federal Managers' Financial Integrity Act of 1982," September 8, 1982 (section 65, title 31, United States Code).

OMB Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, as amended January 25, 1999.

OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended November 20, 1998.

OMB Circular No. A-34, "Instructions on Budget Execution," December 1995, revised November 7, 1997.

OMB Circular No. A-127, "Financial Management Systems," as revised July 23, 1993.

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Director, Defense Logistics Studies Information Exchange

Department of the Army

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

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

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

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Finance and Accounting Service Indianapolis Center
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

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

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

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

Audit Team Members

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

F. Jay Lane
Salvatore D. Guli
Charles J. Richardson
Marvin L. Peek
Jonathan R. Witter
Linda A. Garner
John W. Wright
Jennifer R. Siwula