

Audit Report



INSPECTOR GENERAL, DOD, OVERSIGHT OF THE ARMY AUDIT
AGENCY AUDIT OF THE FY 1999 ARMY WORKING CAPITAL
FUND FINANCIAL STATEMENTS

Report No. D-2000-080

February 23, 2000

Office of the Inspector General
Department of Defense

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Acronym

AAA Army Audit Agency



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2885

February 23, 2000

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

SUBJECT: Audit Report on Inspector General, DoD, Oversight of the Army Audit
Agency Audit of the FY 1999 Army Working Capital Fund Financial
Statements (Report No. D-2000-080)

We are providing this audit report for your information and use and for transmittal to the Director, Office of Management and Budget. It includes our endorsement of the Army Audit Agency disclaimer of opinion on the FY 1999 Army Working Capital Fund financial statements, along with the "Army Working Capital Fund Principal Financial Statements for Fiscal Year 1999: Auditor's Report." An audit of the Army Working Capital Fund financial statements is required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. Because this report contains no findings or recommendations, comments are not required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Richard B. Bird at (703) 604-9159 (DSN 664-9159), e-mail rbird@dodig.osd.mil or Mr. Carmelo G. Ventimiglia at (317) 510-3852 (DSN 699-3852), e-mail cventimiglia@dodig.osd.mil. See Appendix B for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2000-080

(Project No. OFI-2117)

February 23, 2000

**Inspector General, DoD, Oversight of the Army Audit
Agency Audit of the FY 1999 Army Working Capital
Fund Financial Statements**

Executive Summary

Introduction. An audit of the Army Working Capital Fund financial statements is required by 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. We delegated the audit of the FY 1999 Army Working Capital Fund financial statements to the Army Audit Agency. This report provides our endorsement of the Army Audit Agency disclaimer of opinion on the FY 1999 Army Working Capital Fund financial statements, along with the Army Audit Agency report, "Army Working Capital Fund Principal Financial Statements for Fiscal Year 1999: Auditor's Report."

Audit Objective. The audit objective was to oversee the independent audit of the FY 1999 Army Working Capital Fund financial statements conducted by Army Audit Agency. See Appendix A for a discussion of the audit process.

Audit Results. The "Army Working Capital Fund FY 1999 Financial Statements: Auditor's Report," February 10, 2000, stated that the Army Audit Agency was unable to express an opinion on the FY 1999 Army Working Capital Fund financial statements. We concur with the Army Audit Agency disclaimer of opinion; our endorsement of that disclaimer is Exhibit 1. The Army Audit Agency report is Exhibit 2.

Internal Control Structure and Compliance With Laws and Regulations. The Army Audit Agency evaluated the adequacy of internal controls and compliance with laws and regulations in the Army Working Capital Fund. The results are in the Army Audit Agency report.

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- Exhibit 2. Army Audit Agency Report, "Army Working Capital Fund
Principal Financial Statements for Fiscal Year 1999:
Auditor's Report"

Appendix A. Audit Process

Scope and Methodology

Audit Work Performed. To fulfill our responsibilities under 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, we provided oversight of the independent audit conducted by the Army Audit Agency (AAA) of the FY 1999 Army Working Capital Fund financial statements. Our purpose was to determine whether we could rely on the AAA audit. We reviewed the AAA audit approach and planning, and monitored audit progress at key points.

Reviewing AAA Audit Approach and Planning. We used both the "Financial Statement Audit Manual," January 1993, issued by President's Council on Integrity and Efficiency and the "Financial Audit Manual," December 1996, issued by the General Accounting Office, as the criteria for reviewing the AAA audit approach and planning. Specifically, we reviewed the engagement letter, documentation of the entrance conference, strategy formulation, audit plans, and audit programs. We reviewed additional documentation as necessary to accomplish the audit objective. We also participated in audit planning conferences and workshops coordinated by AAA.

Monitoring Audit Progress at Key Points. Through the Inspector General, DoD, Executive Steering Committee, we provided a forum for a centrally managed exchange of information and guidance leading to a focused DoD-wide audit of the consolidated financial statements for major DoD Components. Initiatives for monitoring the progress of the audit at key points include active participation in working groups focused on significant topics for Army Working Capital Fund financial reporting, such as the working groups for the Statement of Budgetary Resources and the Statement of Net Cost. We also reviewed and commented on related draft reports issued by AAA, including the opinion report and the report on the evaluation of internal controls and compliance with laws and regulations.

In addition to the oversight procedures, we performed other procedures necessary to determine the fairness and accuracy of the AAA audit approach and conclusions. For example, we co-performed audit work with AAA to verify the adequacy of support for adjustments made during the compilation of the financial statements.

DoD-Wide Corporate-Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Secretary of Defense established 2 DoD-wide corporate-level goals,

8 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 objective and goal. This report pertains to achievement of the following functional area objective and goal.

- **Financial Management 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.

Audit Type, Period and Standards. We performed this financial statement audit from March 11, 1999, through February 17, 2000. The audit was made 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 to conduct this audit.

Contacts During the Audit. We visited or contacted individuals and organizations in the DoD audit and accounting community. Further details are available on request.

Summary of Prior Coverage

The General Accounting Office and the Inspector General, 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>. Inspector General, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil>.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Comptroller (Program/Budget)
Deputy Chief Financial Officer
Director for Accounting Policy

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

**Exhibit 1. Inspector General, DoD,
Endorsement Memorandum**



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2885

February 17, 2000

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

SUBJECT: Endorsement of the Disclaimer of Opinion on the FY 1999 Army Working Capital Fund Financial Statements (Project No. OFI-2117)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General. We delegated to the Army Audit Agency (AAA) the audit of the FY 1999 Army Working Capital Fund financial statements. Summarized as follows are the AAA disclaimer of opinion on the FY 1999 Army Working Capital Fund financial statements and the results of our review of the AAA audit. The information provided in this memorandum contains reasons for the AAA disclaimer. We endorse the disclaimer of opinion expressed by AAA.

Disclaimer of Opinion. The AAA disclaimer of opinion on the FY 1999 Army Working Capital Fund financial statements, dated February 10, 2000, states that AAA was unable to express an opinion on the financial statements. We concur with the AAA disclaimer of opinion for the reasons summarized as follows.

The AAA concluded that the accounting systems used to account for the Army Working Capital Fund did not have complete general ledger controls, and in some instances, they lacked adequate audit trails. The AAA could not verify the following.

- inventory adjustments made to the financial accounting records,
- inventory in transit from procurement,
- the cost and depreciation recorded for real property and general equipment,
- depot maintenance and ordnance expense transactions reported on the Statement of Net Cost and the Statement of Changes in Net Position, and
- amounts reported on the Statement of Budgetary Resources and the Statement of Financing.

Internal Controls. The AAA determined that internal controls did not provide reasonable assurance that the FY 1999 Army Working Capital Fund financial statements contained no material misstatements. The Army and the Defense Finance and Accounting Service did not do the following:

- reconcile inventory logistical and accounting records,
- design procedures to compensate for automated systems that did not always properly capitalize the cost of buildings and improvements to assets and compute depreciation,
- reconcile general and subsidiary ledgers, and
- maintain audit trails for some transactions.

Specifically, \$137.8 billion in accounting adjustments lacked audit trails. The Army and the Defense Finance and Accounting Service recognized many of the financial reporting weaknesses and reported them in their FY 1999 Annual Statements of Assurance.

Compliance With Laws and Regulations. The AAA also identified areas of noncompliance with laws and regulations. Under the Federal Financial Management Improvement Act of 1996, the AAA work showed that financial management systems did not substantially comply with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transactions level. For example, financial management systems did not maintain audit trails, which is a Federal financial management system requirement. In addition, the Army did not perform appropriate reviews of all of its feeder systems. Details on the adequacy of internal controls and compliance with laws and regulations will be discussed in a separate AAA report.

Review of the Army Audit Agency Work. To fulfill our responsibilities for determining the accuracy and completeness of the independent audit that AAA conducted, we reviewed the audit approach and planning and monitored progress at key points. We also performed other procedures necessary to determine the fairness and accuracy of the approach and conclusions.

We reviewed the AAA work on the FY 1999 Army Working Capital Fund financial statements from March 11, 1999, through February 10, 2000, in accordance with generally accepted Government auditing standards. We found no indications that we could not rely on the AAA disclaimer of opinion or its related evaluation of internal controls and compliance with laws and regulations.



David K. Steensma
Deputy Assistant Inspector General
for Auditing

**Exhibit 2. Army Audit Agency Report,
“Army Working Capital
Fund Principal Financial
Statements for Fiscal
Year 1999: Auditors
Report”**

Army Working Capital Fund Principal Financial Statements for Fiscal Year 1999

Auditor's Report

**10 February 2000
Audit Report: AA 00-177**



U.S. Army Audit Agency





DEPARTMENT OF THE ARMY
OFFICE OF THE AUDITOR GENERAL
3101 PARK CENTER DRIVE
ALEXANDRIA, VA 22302-1596

17 February 2000

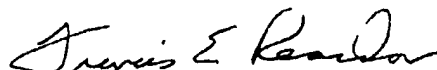
Secretary of the Army

This is our report on our review of internal controls and compliance with laws and regulations related to the Army Working Capital Fund Financial Statements for Fiscal Year 1999. A companion report (Army Working Capital Fund Principal Financial Statements for Fiscal Year 1999, Auditor's Report, 10 February 2000, AA 00-177) contains our disclaimer of opinion. Both reports present the results of our efforts to audit the Army Working Capital Fund FY 99 Financial Statements.

Overall, we found that internal controls weren't fully effective to ensure that there were no material misstatements in the financial statements. Both the Army and the Defense Finance and Accounting Service have acknowledged weaknesses in reporting on certain transactions. As a result, the Army isn't able to fully comply with the requirements of the Chief Financial Officers Act and the related implementing regulations. However, our review of compliance with laws and regulations revealed no material instances of unreported legal or regulatory infractions.

This report doesn't contain recommendations, but it summarizes the results, conclusions, and recommendations in related audit reports we will issue separately.

I appreciate the courtesies and cooperation extended to us during the audit.


FRANCIS E. REARDON, CPA
The Auditor General

For more information about this audit, please call the Army Working Capital Fund Division at (703) 681-8349. For copies of the Summary of Audit or for extra copies of this report, please call (703) 681-9863.

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AUDITOR'S REPORT



DEPARTMENT OF THE ARMY
OFFICE OF THE AUDITOR GENERAL
3101 PARK CENTER DRIVE
ALEXANDRIA, VA 22302-1596

10 February 2000

Secretary of the Army

The Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, requires the Army to prepare annual financial statements for the Army Working Capital Fund. The Inspector General, DOD, is responsible for auditing financial statements within the Department of Defense. The Inspector General, DOD, delegated the responsibility of auditing the Army Working Capital Fund financial statements to us.

The Army and the Defense Finance and Accounting Service have accounting system deficiencies and incomplete audit trails. These issues limited their ability to prepare reliable financial statements for the Army Working Capital Fund for FY 99. These issues also limited our ability to perform detailed tests of the information presented in the financial statements. Both the Army and the Defense Accounting Service have recognized financial reporting problems as material weaknesses and included some of the financial reporting weaknesses in their FY 99 annual assurance statements. They also have ongoing efforts to correct these weaknesses. However, in most instances, the corrections are years away. Our audit efforts didn't disclose any instances of significant unreported failures to comply with laws and regulations related to the Army Working Capital Fund financial statements. We will present details on our review in a separate report on internal controls and compliance with laws and regulations.

We were unable to express an opinion on the Army Working Capital Fund FY 99 Principal Financial Statements. In this report, we explain the reasons for our disclaimer. Except for the limitations on the scope of our work on the Principal Statements as noted in the disclaimer of opinion section of this report, we did our work in accordance with generally accepted government auditing standards and Office of Management and Budget Bulletin 98-08 (Audit Requirements for Federal Financial Statements).

Disclaimer of Opinion

We weren't able to determine whether the accompanying principal financial statements fairly presented the financial position, net cost of operations, changes in net position, use of budgetary resources, and sources and uses of financing resources. The accounting systems used to account for the Army Working Capital Fund didn't have complete general ledger control and, in some instances, lacked adequate audit trails. Because of the accounting system deficiencies, the Army and the Defense Accounting Service used operational systems (supply, logistics, or budgetary systems) or locally developed computer software programs to prepare portions of the statements. However, these systems also had some deficiencies.

In addition, the U.S. General Accounting Office found that information security weaknesses impaired DOD's ability to:

- Control physical and electronic access to systems and data.
- Ensure that software is properly authorized, tested, and functioning.
- Limit employee's ability to perform incompatible functions.

The General Accounting Office stated that functions such as finance have been harmed by system attacks or fraud. DOD was making efforts to correct the deficiencies identified by the General Accounting Office. However, the progress was inconsistent, and weaknesses continued to persist in every area of general controls. (General Accounting Office Report AIMD-99-107, DOD Information Security: Serious Weaknesses Continue to Place Defense Operations at Risk.)

These conditions prevented us from applying other auditing procedures to satisfy ourselves that the reported values for material portions of the financial statements were fairly presented or reliable. Therefore, the scope of our work wasn't sufficient to enable us to express, and we do not express, an opinion on these financial statements.

We believe the accounting and information security weaknesses discussed above may also affect the usefulness of information contained in the accompanying overview and any other financial management information taken from the same data sources used to prepare the financial statements.

Other Financial Information

The consolidating financial information and the information regarding transactions with other Federal agencies aren't a required part of the principal financial statements, and we did not audit and do not express an opinion on the information. The consolidating information is presented for additional analysis of the principal financial statements rather than to present the financial position, net cost of operations, changes in net position, use of budgetary resources, and sources and uses of financing resources. The information regarding transactions with other Federal agencies is required supplemental information.

Reasons for Disclaimer

In the following paragraphs, we summarize our results by financial statement. Complete details on these subjects, including specific recommendations, will be in supporting audit reports that we will issue separately.

Balance Sheet

The Army Working Capital Fund Balance Sheet as of 30 September 1999 reported about \$13.9 billion in total assets, \$678 million in liabilities, and \$13.2 billion in equity. Because of accounting system deficiencies, we couldn't determine whether amounts reported in the balance sheet were reasonable and fairly presented. We discuss some examples of these deficiencies and their impact on the financial statements in the following paragraphs.

Inventory and Related Property, Net. The value of Inventory and Related Property, Net reported at about \$10.6 billion or about 76 percent of the reported asset value, was based on logistical records, not accounting records. The Army believed its logistical system was more reliable than the accounting records. Therefore, it computed the value reported for inventory and related property by adjusting, without reconciling, its accounting records by \$3.8 billion so that they agreed with the logistical records. There were two problems with this approach.

- First, by adjusting and not reconciling the accounting records to match the logistical records, the Army couldn't be sure the inventory balances shown in the balance sheet were reasonable.
- Second, the logistical records sometimes aren't accurate. For example, the storage depots that stored Army Working Capital Fund inventory items reported that they didn't always meet the

DOD inventory accuracy goal of 95 percent. The accuracy rates averaged 92.38 percent, with a low of 86.65 percent at one location. Our tests of physical inventory balances showed similar accuracy rates at depots and retail storage locations.

We were unable to determine whether the amounts recorded in the logistical records or the accounting records were more reasonable to use. However, the low accuracy percentages at the depots decrease the usefulness of the information used to prepare the financial statements.

The Army continued to experience difficulties with inventory held for repair included in the Inventory and Related Property line. The accounting systems don't account for inventory held for repair as required by Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property." Federal Accounting Standard Number 3 requires inventory in need of repair to be valued net of expected repair expense. A repair allowance account should be established containing the estimated cost to repair inventory coded as needing repair. An expense should be recognized equal to the amount to bring the repair allowance account to the estimated cost of repair for items in inventory needing repair. As expenses are incurred to repair the items, the repair allowance account should be reduced. In prior audits, we determined that the estimated repair expense was recorded in the Inventory Allowance for Holding Gains and Losses account. The Defense Finance and Accounting Service-Indianapolis Center used this account to reduce the value of inventory to historical cost. It didn't use the estimated repair expense to reduce the amount of inventory held for repair. The lack of a repair expense also impacts the statement of net cost.

We couldn't satisfy ourselves as to the reasonableness of about \$516 million for inventory in-transit from procurement included in the Inventory and Related Property line item. This account represents assets purchased from contractors for which payments have been made, but receipts haven't been recorded. The Army doesn't account for inventory in-transit from procurement using acceptance and receipt transactions. It computes the value by comparing inventory receipts and disbursements made for inventory purchased. Also, as we reported in prior years, activities weren't correcting rejected transactions. The Army reported a material weakness in its FY 99 annual assurance statement concerning the reliability of information on the value of inventory in-transit and that the value of intranits may be misstated by a significant but unknown amount. We couldn't reasonably use any other auditing procedures to satisfy ourselves as to the reasonableness of the reported amount. The Army has several ongoing actions to resolve the problem. However, until the actions are completed, the reported value will continue to be of limited value.

Property, Plant and Equipment, Net. We weren't able to satisfy ourselves as to the reported value (about \$1.8 billion or about 13 percent of total assets) for property, plant and equipment. The Army doesn't meet Federal Financial Accounting Standards for the financial reporting of real property and general equipment. Federal Financial Accounting Standards Number 6, "Accounting for Property, Plant and Equipment," requires Federal agencies to present fairly the cost and depreciation of these assets in the financial statements. To meet these requirements, the Army must capture the correct acquisition date and cost. In most cases, the Army systems weren't designed to produce such information. As a result, the information on the acquisition date and cost sometimes isn't available or accurate. Also, the Integrated Facilities System, which is currently used to record real property, didn't compute depreciation.

As part of a DOD initiative, the Army engaged two national accounting firms to assist in establishing property, plant and equipment values as required by Statement of Federal Financial Accounting Standards Number 6. These efforts are currently in process. In addition, during FY 99, the Army used the Defense Property Accountability System to account for personal property and planned to implement the system for use in accounting for real property in FY 00. The Property Accountability System should improve the financial accounting of real property.

Statement of Net Cost/Statement of Changes in Net Position

The automated accounting systems used to account for and compile the Statement of Net Cost and the Statement of Changes in Net Position didn't maintain sufficient data to trace transactions from the financial statement to the details in the general ledger. For example, we attempted to test some expense transactions in the Standard Industrial Fund System but couldn't because the automated system didn't produce an audit trail supporting the summary amounts. The Standard Industrial Fund System was used to account for about \$1.8 billion or 16 percent of the program costs reported in the financial statement. We couldn't apply any practical auditing methodology to determine if the summary amount reported for expenses was reliable. Therefore, we couldn't determine if the information was reasonable and fairly stated.

Statement of Budgetary Resources

We couldn't determine whether the amounts in the Statement of Budgetary Resources, including about \$9.9 billion for total budgetary resources, were reasonable and fairly stated because the Indianapolis Center didn't use a standard general ledger to prepare the statement. Data for the statement came from budgetary status reports and the Indianapolis Center's cash expenditure and collection reporting system.

The Indianapolis Center used these sources to prepare the statement because general ledgers produced by the accounting systems at the fiscal stations didn't contain the necessary data. We couldn't tell whether the information used to prepare the statement was reasonable because the amounts reported in the statement were computed using gross numbers without detailed transactions supporting the figures. Additionally, the general ledgers used by the field reporting activities weren't standard. Therefore, we couldn't determine if the data used to prepare the statement was consistent among the activity groups.

When compiling the Statement of Budgetary Resources, the Indianapolis Center made adjustments valued at \$10 billion to field reported budget data and expenditure system data. We tested some of the adjustments and couldn't find an adequate trail to enable us to determine if these adjustments were reasonable or valid. These issues limited the scope of our review and prevented us from reasonably using other auditing procedures to assure ourselves that the amounts reported in the financial statement were reasonable and fairly stated.

Statement of Financing

The Statement of Financing was prepared using information from the same systems that the Indianapolis Center used to prepare the Statement of Net Cost and the Statement of Budgetary Resources. The scope limitations we encountered reviewing those financial statements also affected our ability to determine if the Statement of Financing was fairly presented. Additionally, because of the accounting system deficiencies, the Indianapolis Center wasn't able to reconcile the Army Working Capital Fund's FY 99 budgetary data with proprietary expenses and assets capitalized. Therefore, the Indianapolis Center processed unsupported adjustments of about \$3.1 billion to reconcile the budgetary data with the Statement of Net Cost. Because of the scope limitations we encountered during our review of the Statement of Budgetary Resources and the Statement of Net Cost and the unsupported adjustments, we couldn't determine whether the information included in the Statement of Financing was fairly presented.

Other Reporting Problems

We found other problems that limited our ability to perform sufficient audit work to render an audit opinion. The Army, working with the Defense Accounting Service, must resolve these problems to ensure that affected data is properly presented in the Army Working Capital Fund financial statements.

Financial Management Systems

The Defense Accounting Service's financial management systems didn't meet all requirements of the Federal Financial Management Improvement Act of 1996. The lack of a single integrated general ledger and the differences between certified reports and general ledger accounts caused the financial statement process at the Indianapolis Center to be complicated and lengthy.

Several of our disclaimer points in this report are the result of inadequate accounting systems. The Defense Accounting Service initiated efforts to improve the automated systems. However, many of these efforts will take years to fully implement.

Financial Statement Compilation

The Indianapolis Center continued to experience problems compiling the financial statements. Because of problems with the automated systems, the Indianapolis Center had to process adjustments valued at about \$191.7 billion. These adjustments were made to:

- Implement accounting standard requirements that weren't included in the design of the accounting systems.
- Correct errors made because of accounting system deficiencies.
- Accrue amounts accounted for by other Army or DOD activities.
- Adjust for differences between general ledger trial balances and other accounting or budget reports.

The Defense Accounting Service engaged the services of two national accounting firms to help improve the process. However, the Defense Accounting Service still encountered problems compiling the financial statements. We identified adjustments valued at about \$137.8 billion that weren't supported by sufficient audit trails. We were able to reconstruct an audit trail for adjustments valued at about \$82.8 billion and determine that the adjustments were valid. However, we couldn't reasonably apply other auditing procedures to determine if the remaining adjustments valued at about \$55 billion were valid.

Allowance Account

As we reported in prior years, the Army has problems related to recording and reporting amounts shown in the Allowance for Unrealized Holding Gains and Loss account. The account included costs that

should have been expensed when incurred. Also, some logistical transactions weren't included in the account because the Standard Army Financial Inventory Accounting and Reporting System-Current removed rejected transactions after 90 days without either an electronic or a hard copy of the rejected transactions. As a result, accounting technicians may not have known if rejects had been appropriately corrected. The Army was in the process of replacing the Standard Army Financial Inventory Accounting and Reporting System with a modified system. The modified system is designed to maintain appropriate audit trails to document correction of rejects.

Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," requires inventory to be valued at historical cost or an estimate of historical cost using the allowance account. When the allowance account is used, the balance in the account should represent the difference between inventory at latest acquisition cost and historical cost. Therefore, when inventory is presented net of the allowance account, an estimate of historical cost results. Until the allowance account is modified to exclude costs that should have been expensed and the Standard Army Financial Inventory Accounting and Reporting System Modernization is totally fielded, the balance in the allowance account will not reduce the cost of inventory to an accurate estimate of historical cost.

Progress Areas

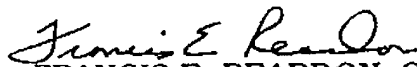
The Army and the Defense Accounting Service are working toward resolving the issues preventing them from preparing reliable financial statements. Each has initiatives in process that should contribute to this goal. For example, during the first part of FY 99, the Army developed a strategic plan to improve the processes and procedures used to account for Army Working Capital Fund assets, liabilities, and transactions. This plan should correct the weaknesses in preparing reliable financial statements. Other key DOD and Army activities responsible for correcting the identified problems participated in the development of the strategic plan.

As we discuss in this report, the Army and DOD have efforts under way to improve the financial reporting of property, plant and equipment. In addition, the Army continued its efforts to implement its Single Stock Fund initiative. This initiative is designed to improve the logistics and financial processes in the Army Working Capital Fund, Supply Management, Army activity group. It represents one of the most sweeping changes to logistics and business processes in the past 25 years. The Single Stock Fund initiative merges wholesale and retail elements of the Army Working Capital Fund, Supply Management, Army below

departmental level into a single, nationally managed fund. This will streamline current operations that have caused numerous inefficiencies, including multiple points of sale and credit, multiple ledgers and billing accounts, and duplicative automated systems managing the same inventory.

Outlook

Both the Army and the Defense Accounting Service recognized the issues that prevented them from preparing reliable financial statements. They remain committed to achieve full compliance with the Chief Financial Officers Act. And, as we discussed earlier, they have actions under way to improve financial reporting and integrate functions and financial reporting as intended by the Chief Financial Officers Act. Although problems remain and solutions are still years away, the outlook is positive.


FRANCIS E. REARDON, CPA
The Auditor General

ANNEXES

AUDIT SCOPE AND METHODOLOGY

Army management, with support provided by the Defense Finance and Accounting Service, is responsible for:

- Preparing the annual financial statements in conformity with applicable accounting principles.
- Establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met.
- Complying with applicable laws and regulations.

In coordination with the DOD Inspector General's office, we were engaged to audit the financial statements and evaluate related internal control and compliance with laws and regulations. In carrying out these responsibilities, we:

- Assessed the accounting principles used by management.
- Obtained an understanding of the internal control structure over financial reporting, safeguarding of assets, and compliance with laws and regulations.
- Evaluated and, as necessary, tested relevant internal controls.
- Tested compliance with selected laws and regulations such as the Chief Financial Officers Act and Office of Management and Budget Circular 97-01, Form and Content of Federal Financial Statements.
- Conducted followup reviews on previous recommendations related to the Army Working Capital Fund.

We didn't conduct audit work on programs that were classified for national security purposes.

To the extent possible, we performed our work in accordance with generally accepted government auditing standards and Office of Management and Budget Bulletin 98-08 (Audit Requirements for Federal Financial Statements). However, as we noted in the body of our report, there were limitations to the scope of our work.

SUPPORTING AUDIT REPORTS
(To Be Issued)

Army Working Capital Fund FY 99 Financial Statements Internal
Controls and Compliance with Laws and Regulations

Internal Controls over Obligations, Disbursements, Orders Received, and
Collections

Internal Controls over Selected Revenue, Expense, and Equity Accounts

Selected Internal Controls over Army Working Capital Fund Inventory

Selected Internal Controls over Accounts Payable

Internal Controls over the Financial Statement Compilation Process

Followup Issues—Army Working Capital Fund Financial Statements

Unexpended Appropriations—Army Working Capital Fund

Selected Internal Controls over the Statement of Financing

OTHERS RECEIVING COPIES OF THIS REPORT

Assistant Chief of Staff of Army (Financial Management and Comptroller)

Director of the Army Staff

The Inspector General

Chief of Public Affairs

Deputy Chief of Staff for Logistics

Deputy Chief of Staff for Personnel

Assistant Chief of Staff for Installation Management

Commanders

U.S. Army Materiel Command

U.S. Army Criminal Investigation Command

3d Military Police Group, U.S. Army Criminal

Investigation Command

Commandant, U.S. Army Logistics Management College

Director, Center for Army Lessons Learned

Under Secretary of Defense (Comptroller)

Inspector General, Department of Defense

Directors

Defense Finance and Accounting Service

Defense Finance and Accounting Service-Indianapolis Center

Defense Intelligence Agency

Auditors General

Air Force Audit Agency

Naval Audit Service

Comptroller General, U.S. General Accounting Office

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