

Audit
Report



COMPILATION OF THE FY 1999 DEPARTMENT OF THE NAVY
WORKING CAPITAL FUND FINANCIAL STATEMENTS

Report No. D-2000-140

June 7, 2000

Office of the Inspector General
Department of Defense

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Acronyms

CDB
DFAS
UADPS

Central Data Base
Defense Finance and Accounting Service
Uniform Automated Data Processing System



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

June 7, 2000

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE
NAVAL INSPECTOR GENERAL

SUBJECT: Audit Report on Compilation of the FY 1999 Department of the Navy
Working Capital Fund Financial Statements (Report No. D-2000-140)

We are providing this report for review and comment. The Director, Defense Finance and Accounting Service, did not respond to the draft report; however, we considered comments from the Assistant Secretary of the Navy (Financial Management and Comptroller) in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Assistant Secretary of the Navy (Financial Management and Comptroller) provided comments on the draft report that were responsive. We request that the Director, Defense Finance and Accounting Service, provide comments on the final report by July 7, 2000.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Marvin L. Peek at (703) 604-9587 (DSN 664-9587) (mpeek@dodig.osd.mil) or Mr. Joel K. Chaney at (216) 522-6091 (DSN 580-6091) (jchaney@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Office of the Inspector General, DoD

Report No. D2000-140

June 7, 2000

(Project No. D2000FC-0045.001)
(formerly Project No. OFC-2113.01)

Compilation of the FY 1999 Department of the Navy Working Capital Fund Financial Statements

Executive Summary

Introduction. This report is the second in a series of reports on the FY 1999 Department of the Navy Working Capital Fund financial statements. Inspector General, DoD, Report No. D-2000-082, "Inspector General, DoD, Oversight of the Naval Audit Service Audit of the FY 1999 Department of the Navy Working Capital Fund Financial Statements," February 14, 2000, addresses our oversight of the financial statement audit conducted by the Naval Audit Service and endorses the disclaimer of opinion that the Naval Audit Service issued.

We performed this audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires DoD to provide audited financial statements to the Office of Management and Budget. The FY 1999 Department of the Navy (Navy) Working Capital Fund financial statements reported total assets of \$23.4 billion and total liabilities of \$5.5 billion. Net program costs for the Navy Working Capital Fund were \$710.9 million.

Objectives. The overall audit objective was to determine whether the Defense Finance and Accounting Service (DFAS) Cleveland Center consistently and accurately compiled and consolidated financial data received from Navy field organizations and other sources to prepare the FY 1999 Navy Working Capital Fund financial statements. We also reviewed procedures for reconciling the inventory general ledger accounts to supporting records and classifying inventory and processes and procedures for recording accounting entries to adjust accounting data provided by the field organizations. In addition, we reviewed management controls and compliance with laws and regulations as they related to the audit objective. See Appendix A for a discussion of the audit process and the DFAS Cleveland Center management control program.

Results. At FY 1999 year-end, DFAS Cleveland Center recorded 233 departmental-level accounting entries, valued at \$604.8 billion, that impacted amounts reported on the FY 1999 Navy Working Capital Fund financial statements. Of the \$604.8 billion, \$549.5 billion were supported, \$48.0 billion were unsupported, and \$7.3 billion were not reviewed. Additionally, 45 of the entries were not approved at the appropriate supervisory level. Also, our review of 276 month-end departmental-level accounting entries, valued at \$626.2 billion, identified \$187.4 billion in unsupported accounting entries. As a result, FY 1999 Navy Working Capital Fund financial statements were subject to a high risk of material misstatement (finding A).

The DFAS Cleveland Center did not ensure that six general ledger account balances were verifiable. As a result, Inventory, Net was overstated on the financial statements by at least \$361,570 and may have been overstated by \$445.4 million (finding B).

The DFAS Cleveland Center erroneously classified two general ledger accounts as inventory that it should have classified as accounts receivable. As a result, Inventory, Net was overstated by \$44.5 million and accounts receivable were understated (finding C).

Summary of Recommendations. We recommend that the Director, DFAS Cleveland Center, publish and implement standard operating procedures for documenting and processing journal vouchers that comply with the guidance that the DFAS Director for Accounting provided. We also recommend that the Director, DFAS, modify the Defense Business Management System to provide accounting data in a format that is compatible with posting logic in the Central Data Base system. We recommend that DFAS with support from Navy Working Capital Fund organizations reconcile general ledger account balances for inventory with the financial records and other supporting records that the organizations maintain. In addition, we recommend that DFAS classify "Property Returned to Government for Credit" and "Property Returned to Suppliers for Credit" as accounts receivable instead of inventory.

Management Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred with the recommendation to support DFAS in reconciling general ledger inventory records with other supporting records. We revised two recommendations included in the draft report based on comments received from the Assistant Secretary of the Navy (Financial Management and Comptroller). The Director, Defense Finance and Accounting Service, did not comment on the draft report. Therefore, we request that the Director, Defense Finance and Accounting Service, provide comments on the final report by July 7, 2000.

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Background

The audit was performed as part of our effort to meet the requirements of 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. This report is the second in a series of reports on the Department of the Navy Working Capital Fund financial statements. Inspector General, DoD, Report No. D-2000-082, "Inspector General, DoD, Oversight of the Naval Audit Service Audit of the FY 1999 Department of the Navy Working Capital Fund Financial Statements," February 14, 2000, addresses our oversight of the financial statement audit that the Naval Audit Service conducted and endorses the disclaimer of opinion that the Naval Audit Service issued. This part of our audit focused on the Defense Finance and Accounting Service (DFAS) Cleveland Center processes and procedures to compile financial data received from Navy field organizations and other sources to prepare the FY 1999 Department of the Navy¹ Working Capital Fund financial statements.

Navy Working Capital Fund. The FY 1999 Navy Working Capital Fund financial statements reported total assets of \$23.4 billion and total liabilities of \$5.5 billion. Net program costs for the Navy Working Capital Fund were \$710.9 million. The Navy Working Capital Fund finances nine primary activity groups, which provide support to the Navy and other authorized customers. The largest activity group is the Supply Management activity group, which reported "Inventory, Net"² of \$14 billion (58 percent of total assets) in the FY 1999 financial statements.

Defense Finance and Accounting Service. The DFAS Cleveland Center performs accounting functions and prepares the financial statements for the Navy Working Capital Fund. Each month, DFAS Cleveland Center receives financial information in various forms from Navy Working Capital Fund field organizations and records the data into the Central Data Base (CDB) accounting system. The DFAS Cleveland Center consolidates the financial data for each activity group and prepares both the monthly reports and annual financial statements for the Navy Working Capital Fund. As part of the compilation process, DFAS Cleveland Center records accounting entries in the CDB accounting system and in off-line financial reporting systems.

Preparation of the Navy Working Capital Fund Financial Statements. At the end of FY 1999, DFAS Cleveland Center departmental accountants performed the month-end processing functions and produced both the monthly reports and an official trial balance from the CDB system. The official trial balance in the CDB chart-of-account format was then converted, or crosswalked, by the DFAS departmental accountants into a U.S. Government Standard General Ledger format. After the financial data were in a standardized format, the information was uploaded into an access database referred to as the

¹The Department of the Navy includes both the Navy and the Marine Corps. However, in this report, the term "Navy" will refer to the Department of the Navy, unless specified as the Navy Component.

²"Inventory, Net" is the term used in the financial statements in Note 8.A. that refers to inventory amounts in various categories after adding or deducting allowable gains or losses.

"Chief Financial Officers Financial Statement Application." The application crosswalked the trial balance in U.S. Government Standard General Ledger format into the FY 1999 Chief Financial Officers financial statements. The application was to be used by all DoD organizations to produce the FY 1999 financial statements. The purpose of the application was to standardize the transfer and conversion of financial data to the financial statements throughout DoD.

Objectives

The overall audit objective was to determine whether DFAS Cleveland Center consistently and accurately compiled financial data received from Navy field organizations and other sources to prepare the FY 1999 Navy Working Capital Fund financial statements. We reviewed the DFAS Cleveland Center's processes for consolidating and summarizing financial data from Navy Working Capital Fund field organizations and procedures for reconciling the inventory general ledger accounts to supporting records and classifying inventory. We also reviewed the DFAS Cleveland Center's processes and procedures for recording accounting entries to adjust accounting data that Navy field organizations provided. In addition, we reviewed management controls and compliance with laws and regulations as they related to the audit objective. See Appendix A for a discussion of the audit process and the DFAS Cleveland Center management control program.

A. Accounting Entries

At FY 1999 year-end, DFAS Cleveland Center recorded 233 departmental-level accounting entries, valued at \$604.8 billion, that impacted amounts reported on the FY 1999 Navy Working Capital Fund financial statements. Of the \$604.8 billion, \$549.5 billion were supported, \$48.0 billion were unsupported, and \$7.3 billion were not reviewed. Also, 45 of the entries were not approved at the appropriate supervisory level. In addition, review of 276 month-end departmental-level accounting entries, valued at \$626.2 billion, showed 128 entries, valued at \$187.4 billion, were unsupported. Accounting entries lacked support and proper approval because operational controls governing the journal voucher process at DFAS Cleveland Center were not in compliance with DoD and DFAS guidance. As a result, FY 1999 Navy Working Capital Fund financial statements were subject to a high risk of material misstatement.

Adjustment Guidance

DoD Regulation 7000.14-R, the "DoD Financial Management Regulation," volume 6, "Reporting Policies and Procedures," February 12, 1996, requires DFAS to establish procedures to ensure that the preparation of financial statements is timely and auditable and that controls are in place to provide accurate and complete statements. The regulation states that DFAS is to support adequately and justify in writing any adjustment to the official accounting records. The regulation also provides that the documentation of accounting entries should be detailed enough to provide an audit trail.

DFAS Director for Accounting Memorandum, "Journal Voucher Guidance," October 28, 1999, provides additional guidance for accounting entries. The guidance prescribes operational internal controls for journal voucher processing. The guidance categorizes journal vouchers by type and establishes specific documentation requirements for support of each adjustment type. The guidance also establishes supervisory approval requirements based on the dollar value of the journal voucher and documentation requirements.

Accounting Entries

During FY 1999, DFAS Cleveland Center recorded 233 year-end accounting entries and 872 month-end accounting entries. The 1,105 accounting entries had a total debit value of \$1,271.7 billion. Table 1 shows the results of our review of the accounting entries.

| Accounting Entry Type | Supported (entries) | Unsupported (entries) | Not Reviewed (entries) | Total (entries) |
|-------------------------------------|--------------------------|--------------------------|-------------------------|------------------------------|
| Year-End Accounting Entries | | | | |
| Supply Management | \$ 21.0 (13) | \$ 6.3 (8) | \$4.1 (135) | \$ 31.4 (156) |
| Industrial Fund | 0 (0) | 25.5 (18) | 3.2 (24) | 28.7 (42) |
| Cost of Goods Sold Model | 528.0 (20) | 0 (0) | 0 (0) | 528.0 (20) |
| Financial Statement Application | 0.5 (2) | 16.2 (13) | 0 (0) | 16.7 (15) |
| Subtotal | \$549.5 (35) | \$48.0 (39) | \$7.3 (159) | \$604.8 (233) |
| Month-End Accounting Entries | | | | |
| Supply Management | 425.5 (119) | 18.6 (22) | 27.9 (416) | 472.0 (557) |
| Industrial Fund | 13.3 (29) | 168.8 (106) | 12.8 (180) | 194.9 (315) |
| Subtotal | \$438.8 (148) | \$187.4 (128) | 40.7 (596) | 666.9 (872) |
| Total | \$988.3 (183) | \$235.4 (167) | \$48.0 (755) | \$1,271.7 (1,105) |

Unsupported Accounting Entries

During FY 1999, the DFAS Cleveland Center did not adequately support 167 accounting entries, valued at \$235.4 billion. The unsupported entries

included 128 month-end accounting entries, with a debit value of \$187.4 billion, and 39 year-end accounting entries, with a debit value of \$48.0 billion. Of the 167 unsupported accounting entries, 154 entries were recorded in the Supply Management and Industrial Fund subdivisions of the CDB and 13 entries were recorded in the Chief Financial Officers Financial Statement Application.

Accounting Entries for the Supply Management Business Area. During FY 1999, DFAS Cleveland Center recorded 30 accounting entries in the Supply Management subdivision of the CDB without adequate supporting documentation. Our review concluded that 22 month-end accounting entries, valued at \$18.6 billion, and 8 year-end accounting entries, valued at \$6.3 billion, were unsupported.

Accounting Entries to Correct Errors. Of the 30 unsupported accounting entries, 25 accounting entries, valued at \$18 billion, represented accounting entries necessary to correct errors that occurred when recording Defense Business Management System information in the CDB.

The October 28, 1999, memorandum from the DFAS Director for Accounting provides guidance for documenting journal voucher entries to correct errors identified during the financial report preparation and review process. Evidence to support that type of journal voucher includes a detailed listing of the errors identified and related analysis documenting the correct amount. Documentation includes specific amounts, accounts, and transactions related to the correction required. Generally, the correcting journal voucher should reverse the incorrect entry in its entirety and record the correct entry simultaneously.

The Defense Business Management System provided accounting data in a format that was not compatible with CDB posting logic. The CDB was designed to record transactions occurring during the accounting period (current month) and to accumulate the general ledger account balances at the end of the accounting period. However, the electronic submission from the Defense Business Management System did not summarize transactions during the accounting period. Instead, the Defense Business Management System provided a trial balance at the end of each month. The trial balance reported account balances based on inception to date or year to date transactions. When the Defense Business Management System data were recorded in the CDB, errors, including out-of-balance conditions, occurred. The accounting entries to correct that type of error could be eliminated by a system change to the Defense Business Management System.

Although DFAS Cleveland Center prepared journal vouchers to correct the errors, the accounting adjustments included debit and credit entries that did not balance and proprietary and budgetary accounting entries that were not self-balancing. In addition, the documentation accompanying the journal vouchers included only a summary identifying the organizations and general ledger accounts affected. The documentation did not include detailed information representing an audit trail to document each specific error being corrected. The October 28, 1999, memorandum specifies that support for the adjustment should include source data documentation and related analysis, which explain why the error occurred, document the correct amount, and provide a detailed listing of the errors.

Other Unsupported Accounting Entries. The remaining five unsupported accounting entries, valued at \$6.9 billion, were various types of accounting entries for which documentation accompanying the journal voucher did not provide sufficient information to evaluate the entry.

Accounting Entries for the Industrial Fund Business Area. During FY 1999, DFAS Cleveland Center recorded 124 accounting entries in the Industrial Fund subdivision of the CDB without adequate supporting documentation. Our review concluded that 106 month-end entries, valued at \$168.8 billion, and 18 year-end accounting entries, valued at \$25.5 billion, were unsupported.

Undistributed Collections and Disbursements. Of the 124 unsupported accounting entries, 100 accounting entries, valued at \$156 billion, were based on calculations that DFAS Cleveland Center made. The DFAS Cleveland Center calculated the difference between collections and disbursements recorded in the general ledger accounts for each Industrial Fund organization and the Centralized Expenditure and Reimbursement Processing System activity control ledger balances. The DFAS Cleveland Center accounting network did not capture the detail transactions comprising the amount of the accounting entry.

On August 23, 1999, the DFAS Director for Accounting issued a memorandum on "Fund Balance With Treasury-Undistributed." In that memorandum, the Director specified that all undistributed collections and disbursements must be fully supported with detailed transactions and may no longer be estimates or calculations. The DFAS Cleveland Center's plan to remedy the undistributed collection and disbursement problems involved systems initiatives, cash accountability initiatives, and policy initiatives that could not be implemented by the end of FY 1999.

The October 28, 1999, memorandum permits journal vouchers to be posted based on summary-level collection and disbursement data. The support required for that type of transaction consists of the summarized collection and disbursement amounts. However, for audit trail purposes, the detailed transaction-level amounts are to be obtained from the transmittal source, when it becomes available.

DFAS Cleveland Center was unable to provide us with the summary-level data or detailed transactions to support the undistributed disbursement and collection accounting entries made throughout FY 1999. Those adjustments were unsupported because the adjustment was made to force field-level disbursement and collection amounts into agreement with amounts reported to the U.S. Treasury, without detailed transaction information.

Undistributed Collections and Disbursements for Navy Component. Of the 124 unsupported accounting entries, 10 entries, valued at \$18.8 billion, were recorded in the Navy Component business area of the CDB to record undistributed disbursements and collections. That type of adjustment was required to account for disbursements and collections reported to the U.S. Treasury for the Navy Working Capital Fund that were not identifiable to a Navy Working Capital Fund activity group or business area. Each month, DFAS Cleveland Center recorded an accounting adjustment to reverse the prior

month balances and record current month undistributed disbursement and collection values. The detailed transactions that supported the general ledger values for undistributed collections and disbursements were not available from DFAS Cleveland Center.

Budgetary Accounting Entries. Of the 124 unsupported month-end accounting entries, 7 entries, valued at \$15.2 billion, were recorded in the CDB to populate budgetary accounts using data contained in Reports on Budget Execution (SF-133). The budgetary accounts should have been populated at the transaction level. However, the field-level accounting systems for the Navy Working Capital Fund industrial fund organizations do not perform budgetary accounting at the transaction level. Instead, accounting personnel at DFAS Cleveland Center derived the budgetary information from other sources including the SF-133 and proprietary general ledger accounts. The Navy Working Capital Fund is in the process of implementing new accounting systems that will contain both proprietary and budgetary account structures and allow budgetary accounts to be populated at the transaction level.

Other Unsupported Accounting Entries. The remaining seven unsupported accounting entries, valued at \$4.3 billion, were various types of accounting entries for which documentation accompanying the journal voucher did not provide sufficient information to evaluate the entry.

Accounting Entries Recorded in the Chief Financial Officers Financial Statement Application. Of the 15 journal vouchers, valued at \$16.7 billion, recorded in the Chief Financial Officers Financial Statement Application in support of version 2 of the financial statements, 13 accounting entries, valued at \$16.2 billion, were not adequately supported. In some cases, no documentation was included with the journal voucher. The October 28, 1999, memorandum requires that support for the journal voucher include source data documentation and related analyses of how the amount was determined. Examples of unsupported accounting entries follow:

- Journal voucher no. 8 recorded debits totaling \$617 million to Operating Expenses and Undelivered Orders-Unpaid and credits totaling \$617 million to Accounts Payable and Expended Authority-Unpaid. The justification provided was to increase accounts payable and expenses for the amount of undistributed collections. The journal voucher adjusted accounts payable to compensate for intra-governmental eliminations. The supporting documentation referenced a computation on a spreadsheet for the reconciliation of an elimination entry. The spreadsheet did not identify how the \$617 million was calculated, provide an audit trail to supporting records, or even show the \$617 million on the spreadsheet.
- Journal voucher no. 7 recorded a debit of \$116 million to decrease "Anticipated Transfers-Prior-Year Authority" and a credit entry of \$116 million to "Transfers-Prior-Year Authority." The reason annotated for the adjustment was to change the Statement of Budgetary Resources to match the financial statements submitted by the Marine Corps Supply Management business area. No supporting documentation was attached to the journal voucher.

Approval of Accounting Entries

The memorandum from the DFAS Director for Accounting established supervisory approval levels for accounting entries. Of the 74 year-end accounting entries we reviewed, 45 entries were not approved at the appropriate supervisory level: 20 entries should have been approved by the Director, DFAS Cleveland Center; 14 entries should have been approved by the Director of Accounting, DFAS Cleveland Center; 10 entries should have been approved by the Director of Departmental Accounting, DFAS Cleveland Center; and 1 entry should have been approved by a team leader in Departmental Accounting. The accounting entries were not approved at the proper supervisory levels because DFAS Cleveland Center did not implement the DFAS guidance.

Summary

The DFAS Cleveland Center did not implement the operational controls outlined in the October 28, 1999, memorandum from the DFAS Director for Accounting. As a result, the year-end accounting entries recorded in the CDB and the Chief Financial Officers Financial Statement Application were not adequately documented or approved by the appropriate supervisory level. That condition represents a material management control weakness that could affect the accuracy of the accounting records and the financial statements.

The Navy Working Capital Fund is in the process of implementing new accounting systems that will contain both proprietary and budgetary account structures and allow budgetary accounts to be populated at the transaction level. In addition, DFAS Cleveland Center established a plan to remedy the undistributed collection and disbursement problems that involves systems initiatives, cash accountability initiatives, and policy initiatives. Full implementation of those actions would eliminate the need for accounting entries to populate budgetary general ledger accounts and provide detailed support for the entries to record undistributed collections and disbursements.

Recommendations

A.1. We recommend that the Director, Defense Finance and Accounting Service Cleveland Center, publish and implement standard operating procedures for documenting and processing journal vouchers that comply with the guidance of the Defense Finance and Accounting Service Director for Accounting.

A.2. We recommend that the Director, Defense Finance and Accounting Service, modify the Defense Business Management System to provide accounting data in a format that is compatible with Central Data Base posting logic.

Management Comments Required

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

B. Reconciliation of General Ledger Accounts to Subsidiary Records

We were not able to verify the balances of six general ledger accounts included in Inventory, Net in the FY 1999 Navy Working Capital Fund financial statements. The balances were unverifiable because the DFAS Cleveland Center and Navy Working Capital Fund supply management organizations did not execute procedures to reconcile the Central Data Base (CDB) general ledger account balances to line-item accountability records and other supporting documents. As a result, Inventory, Net was overstated on the FY 1999 financial statements by at least \$361,570 and may have been overstated by an additional \$445.4 million.

Guidance for Reconciling General Ledger Account Balances to Line-Item Accountability Records or Supporting Records

DoD Regulation 7000.14-R, volume 11B, "Reimbursable Operations," chapter 55, "Supply Management Operations," requires line-item accountability records to be reconciled to balances recorded in the general ledger inventory accounts at least quarterly. Differences between line-item accountability records and general ledger balances should be investigated to determine the causes of the differences.

The DoD Regulation 7000.14-R, volume 6, chapter 2, "Departmental Financial Reports Roles and Responsibilities," requires reconciliation of general ledger balances with the amounts recorded in supporting records. Because Navy Working Capital Fund supply management organizations maintain the subsidiary records, the reconciliation of the supporting records with the general ledger account balance is a joint responsibility of DFAS and each applicable organization. Volume 6 also requires that unreconciled differences be investigated and appropriate adjustments documented and processed to balance the general ledger amount with the subsidiary records. In addition, volume 6 provides that when unreconcilable differences between the general ledger and the subsidiary records exceed \$1 million, the reconciliation should be performed on a monthly basis to determine the cause of the differences and to take appropriate actions to ensure the accuracy and integrity of the accounting system and monthly reports.

Reconciliation of General Ledger Accounts to Line-Item Accountability Records

Navy fleet and industrial supply centers maintained line-item accountability records for on-hand inventory using the Uniform Automated Data Processing System (UADPS), and they reported financial information to DFAS Cleveland Center using the Financial Inventory Report process. The UADPS has a financial module that maintains the value of on-hand inventory. At the end of

each month, the fleet and industrial supply centers reconciled their line-item accountability records to the inventory value maintained in the UADPS financial module. Appropriate adjustments to the line-item accountability records or financial records were made by the fleet and industrial supply centers when research of the differences was completed.

However, the fleet and industrial supply centers, DFAS Operating Location Norfolk and DFAS Cleveland Center, did not reconcile the UADPS financial values to the CDB general ledger account number 152131, "Inventory for Agency Operations." As a result, the general ledger account balances in the CDB were \$361,570 greater than the value in the line-item accountability records for the three fleet and industrial supply centers reviewed.

Table 2. Comparison of General Ledger Account Balances to the Value of Line-Item Accountability Records

| <u>Fleet and Industrial Supply Center</u> | <u>CDB General Ledger Account Balance</u> | <u>Line-Item Record Value</u> | <u>Difference</u> |
|---|---|-------------------------------|-------------------|
| Norfolk | \$173,949,260 | \$173,313,853 | \$635,407 |
| San Diego | 169,734,411 | 170,012,519 | (278,108) |
| Jacksonville | 67,517,466 | 67,513,195 | <u>4,271</u> |
| Total | | | \$361,570 |

Reconciliation of General Ledger Accounts to Supporting Records

The Navy Working Capital Fund organizations and DFAS Cleveland Center did not reconcile inventory-related general ledger account balances to supporting records maintained by the Navy Working Capital Fund organizations as of September 30, 1999. As a result, general ledger account balances for inventory may have been overstated by \$445.4 million.

The Navy Working Capital Fund was consolidating supply management financial feeder systems. The consolidations reduced the number of organizations reporting using the Financial Inventory Report reporting process from 105 organizations in September 1997 to 21 organizations in September 1999. Ships converted from the Shipboard Uniform Automated Data Processing System to the Retail Afloat System. Many shore-based organizations partnered with fleet and industrial supply centers, which consolidated logistical management systems. Other shore-based organizations were closed.

During FY 1999, the Navy Working Capital Fund organizations and DFAS Cleveland Center recorded accounting entries to eliminate the residual balances for the ships that converted to the Retail Afloat System and for shore-based organizations that were either partnered with the fleet and industrial supply centers or closed. However, those accounting entries did not correct all of the general ledger account balances for inventory. At the end of FY 1999, general ledger account balances remained for organizations that no longer reported using the Financial Inventory Report reporting process. The DFAS Cleveland Center and the Navy Working Capital Fund organizations did not reconcile the general ledger balances to the organizations' supporting records, and the balances were not adjusted before the organizations consolidated or closed. Table 3 shows a breakout of unreconciled amounts.

| <u>CDB Account</u> | <u>Title</u> | <u>Unreconciled Amount</u> |
|--------------------|---|----------------------------|
| 15211 | Inventory In-Transit From Procurement | \$ 682,618 |
| 152123 | Stock In-Transit (Inventory Control Points) | (251,678) |
| 152124 | Stock In-Transit (Stock Points) | 7,086,418 |
| 152127 | Inventory In-Transit Between Locations | (69) |
| 152131 | Inventory for Agency Operations | 1,514,298 |
| 15231 | Inventory In-Transit From Customers | <u>436,342,805</u> |
| Total | | \$445,374,392 |

Recommendations, Management Comments, and Audit Response

Recommendations Revised. Based on comments on the draft report from the Assistant Secretary of the Navy (Financial Management and Comptroller), we revised recommendations B.1. and B.2 to more clearly indicate the DFAS responsibility for initiating reconciliations.

B.1. We recommend that the Director, Defense Finance and Accounting Service Cleveland Center, with support from applicable Navy Working Capital Fund supply organizations, reconcile general ledger account balances in the Central Data Base system with financial records in the Uniform Automated Data Processing System.

B.2. We recommend that the Director, Defense Finance and Accounting Service Cleveland Center, with support from applicable Navy Working Capital Fund supply organizations, reconcile the inventory related general ledger account balances to supporting records that the organizations maintain.

Management Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred in principle with the recommendations, but noted that DoD Regulation 7000.14-R requires DFAS to initiate the reconciliation process.

Audit Response. Comments from the Assistant Secretary of the Navy (Financial Management and Comptroller) were fully responsive. The DFAS is responsible for scheduling the reconciliation, although the Navy Working Capital Fund organizations are responsible for validating the accuracy of the general ledger balances by comparison to financial values recorded in feeder systems or other supporting documents, when required. The Director, DFAS Cleveland Center, did not comment on a draft of this report. We request that the Director provide comments on the final report.

C. Compilation of Financial Information for Inventory

The DFAS Cleveland Center incorrectly included two general ledger accounts as inventory that should have been reported as accounts receivable. The inaccurate reporting of inventory occurred because the Cost of Goods Sold model as designed by DFAS and the Under Secretary of Defense (Comptroller) misclassified the general ledger accounts as inventory. As a result, Inventory, Net was overstated by \$44.5 million and accounts receivable were understated.

Guidance for Reporting Inventory

DoD Regulation 7000.14-R, volume 11B, Chapter 55 establishes accounting policy for DoD Components to use in reporting inventory balances on their financial statements. The regulation provides that inventory is tangible personal property, titled to the Government, that is on hand or in-transit (for example, accepted at origin from a vendor, or moving between DoD organizations) and is held for sale, future sale, repair, or pending transfer to disposal. Inventory should be recognized when the title passes to the purchasing entity or when goods are delivered to the acquiring entity, whichever occurs first.

Compilation of Inventory

The DFAS Cleveland Center calculated inventory using the Cost of Goods Sold model developed by the Under Secretary of Defense (Comptroller) and DFAS. Inventory for the Navy Supply Management business area, at latest acquisition cost, totaled \$22.8 billion and was composed of the following categories shown in Table 4.

| | |
|-------------------------------------|-------------------------|
| Inventory Held for Sale | \$13,766,394,711 |
| Inventory Held for Future Sale | 85,334,929 |
| Inventory Held for Repair | 8,843,378,112 |
| Excess, Obsolete, and Unserviceable | <u>130,960,079</u> |
| Total | \$22,826,067,831 |

Using the Cost of Goods Sold model, DFAS Cleveland Center classified two general ledger accounts, totaling \$44.5 million, as Inventory Held for Sale that should have been classified as accounts receivable:

- account no. 15901, "Property Returned to Government for Credit," and
- account no. 15902, "Property Returned to Suppliers for Credit."

The two general ledger accounts accumulate the value of inventory that has been returned (shipped) to the supplier for credit (another DoD inventory control point or commercial supplier). The general ledger accounts do not represent inventory on-hand or inventory in-transit to or between Navy Working Capital Fund organizations. Instead, the general ledger accounts represent claims by the Navy Working Capital Fund against other entities. General ledger account no. 15901 should have been classified as "Accounts Receivable, Government," and general ledger account no. 15902 should have been classified as "Accounts Receivable, Public."

Recommendation

C.1. We recommend that the Director, Defense Finance and Accounting Service, classify "Property Returned to Government for Credit" and "Property Returned to Suppliers for Credit" as accounts receivable instead of inventory.

Management Comments Required

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

Appendix A. Audit Process

Scope

We examined the processes and procedures used to prepare the Navy Working Capital Fund financial statements. Our review included procedures and controls over processes to consolidate and adjust financial data from Navy field organizations and other sources to prepare the FY 1999 Navy Working Capital Fund financial statements.

Limitations to Audit Scope. We did not examine the transactions supporting the financial data that Navy field organizations and other sources submitted. We did not evaluate the financial information presented in the Notes to the Navy Working Capital Fund financial statements because DFAS Cleveland Center did not provide the crosswalks and audit trails to the supporting financial information. In addition, we did not review accounting entries recorded in the Chief Financial Officers Financial Statement Application for the final version of the Navy Working Capital Fund financial statements published on February 9, 2000, because DFAS Cleveland Center did not provide information on those accounting entries in time for us to complete our review.

Audit of the FY 1999 Navy Working Capital Fund Financial Statements. The Inspector General, DoD, delegated the audit of FY 1999 financial statements to Naval Audit Service. The Naval Audit Service performed work at the Navy field organizations to reconcile financial data submitted by the organizations to DFAS and the subsidiary records at the organizations. The Inspector General, DoD, and the Naval Audit Service auditors jointly performed audit work on accounting entries made to financial data after receipt of the data into the Central Data Base system. The Naval Audit Service disclaimed an opinion on the FY 1999 Navy Working Capital financial statements, and we endorsed the disclaimer.

DoD-Wide Corporate-Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, 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 goals, subordinate performance goals, and performance measures:

FY 2001 DoD 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 finance 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 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 DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

We reviewed the process that DFAS Cleveland Center used to record, consolidate, and summarize financial information from Navy field-level organizations and other sources. In addition, we reviewed DFAS Cleveland Center and Navy Working Capital Fund procedures for reconciling the inventory values recorded in the general ledger accounts and the values recorded in the Navy Working Capital Fund organizations' subsidiary records. We also analyzed the DFAS Cleveland Center's compilation of information for Inventory, Net shown in the financial statements.

We reviewed the procedures and management controls that DFAS Cleveland Center and the Naval Supply Systems Command used to make accounting entries to the accounting data. During FY 1999, the Naval Supply Systems Command and DFAS Cleveland Center recorded 1,070 accounting entries, valued at \$727.1 billion, in the CDB. The 1,070 accounting entries recorded in the CDB included 872 month-end accounting entries, with a debit value of \$666.9 billion, and 198 year-end accounting entries, with a debit value of \$60.1 billion. In some cases, month-end entries were reversed during the following month and therefore did not affect the annual financial statements. We reviewed 276 of the 872 month-end accounting entries and 39 of the 198 year-end adjustments recorded in the CDB. The 315 accounting entries had a total debit value of \$679 billion. The 315 accounting entries were judgmentally selected and included 294 accounting entries with a value greater than \$300 million each.

In addition, we reviewed the 20 accounting entries, with a total debit balance of \$528 billion, recorded in the Cost of Goods Sold model, and the 15 accounting entries, with a total debit value of \$16.7 billion, recorded in the Chief Financial Officers Financial Statement Application for the version of the financial

statements provided to the auditors on December 23, 1999. Our review included an evaluation of the adequacy of support for the adjustment and the effectiveness of management controls over the adjustment process.

Our review included 106 month-end and 4 year-end accounting entries recorded by the Naval Supply Systems Command recorded and the 20 year-end accounting entries that the DFAS recorded in the Cost of Goods Sold model. For the purposes of this report, those 130 accounting entries were considered supported. The accuracy of those accounting entries will be discussed in a separate audit report.

Computer-Processed Data. The DFAS Cleveland Center used the CDB to consolidate and summarize financial information recorded in various field-level systems. We did not evaluate the financial information reported to the CDB, nor did we evaluate the general or application controls over the CDB. We concluded that the data were sufficiently reliable to meet the audit objective. Not evaluating the controls did not affect the results of the audit.

Audit Type, Period, and Standards. We performed this financial related audit from March 24, 1999, through March 31, 2000, in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, based on the objectives of the audit and the limitations discussed in the scope and methodology.

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

Management Control Program

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the management controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the DFAS Cleveland Center management controls over the processing of accounting entries to financial data within the CDB and the Chief Financial Officers Financial Statement Application for the preparation of the FY 1999 Navy Working Capital Fund Chief Financial Officers financial statements.

Adequacy of Management Controls. We identified material control weaknesses as defined by DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996. Management controls at DFAS Cleveland Center were not adequate to ensure that all accounting entries were adequately supported and properly approved. In addition, management controls did not ensure that inventory general ledger balances were reconciled to line-item accountability records. Recommendation A.1., if implemented, will improve the adjustment process at DFAS Cleveland Center and reduce the

number and amount of unsupported accounting entries that are recorded. Recommendations B.1. and B.2., if implemented, will result in more reliable financial statements. A copy of this report will be provided to the senior official in charge of management controls at DFAS Cleveland Center.

Adequacy of Management's Self-Evaluation. Managers at DFAS Cleveland Center did not identify the processing of journal voucher adjustments as an assessable unit; therefore, they did not identify or report the management control weaknesses identified by the audit.

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 Chief Financial Officer
Director, Accounting Policy
Deputy Comptroller (Program/Budget)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Naval Inspector General
Auditor General, Department of the Navy
Commander, Naval Supply Systems Command

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 Cleveland Center
Director, Defense Finance and Accounting Service Kansas City Center
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations and Individuals

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

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Department of the Navy Comments



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D C 20318 1000

7540
MAY 16 2000

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Subj: DRAFT AUDIT REPORT ON COMPILEATION OF THE FY 1999
DEPARTMENT NAVY WORKING CAPITAL FUND FINANCIAL STATEMENTS
(PROJECT NO. D2000FC-0045.001)

Ref: (a) DODIG memo of 7 Apr 00

Encl: (1) DON Comments on DODIG Draft Audit Report

By reference (a), you requested comments regarding the
subject draft report. Comments are provided in enclosure (1).

The point of contact is Mr. Ed Johnson at (202) 685-6703.

A. A. Tisone
A. A. TISONE
Director
Office of Financial Operations

Copy to:
COMNAVSUPSYSCOM

DEPARTMENT OF THE NAVY COMMENTS
ON
DODIG DRAFT AUDIT REPORT
"COMPILATION OF THE FY 1999 DEPARTMENT OF THE NAVY
WORKING CAPITAL FUND FINANCIAL STATEMENTS"
(Project No. D2000YC-0045.001)

**Finding B: RECONCILIATION OF GENERAL LEDGER ACCOUNTS TO
SUBSIDIARY RECORDS.**

Recommendation for Corrective Action

B.1 We recommend that the Director, Defense Finance and Accounting Service (DFAS) and the Commander, Naval Supply Systems Command (NAVSUPSYSCOM) reconcile the Central Data Base (CDB) general ledger account balances with the Uniform Automated Data Processing System (UADPS) financial and line-item accountability records.

Revised

Department of the Navy Comment

Concur in principle. The recommended reconciliation process from the CDB to line-item accountability records is not possible with the current system. Instead, as discussed in the audit, the Uniform Automated Data Processing System internally reconciles the line-item accountability records (master stock item record) to the financial inventory control ledger or standard general ledger through a sequential reconciliation process. DFAS reconciles the CDB to the financial inventory control ledger or standard general ledger in accordance with Department of Defense (DoD) Financial Management Regulation FMR: Volume 6, Chapter 2, paragraph 020204. Specifically, paragraph 020204.B states that "The DFAS shall establish procedures to ensure that all general ledger balances and other associated financial balances reconciled, at least on a quarterly basis... with the amounts contained in the supporting records, including original source data." Additionally, paragraphs 020204.A and 020204.B state DoD Component customer participation may be required in the reconciliation process if subsidiary records or source documents are maintained by the DoD Component customer, but DFAS still establishes the reconciliation schedule. Whether DFAS or the DoD Component customer holds required records, it is a DFAS responsibility to initiate reconciliation actions. Therefore, the recommendation should only be addressed to the Director, DFAS. We request the recommendation be written as follows: "We recommend the Director, DFAS, with support from applicable NWCFC supply activities as required, reconcile the CDB general ledger account balances with the UADPS financial records."

Encl (1)

Final Report
Reference

Revised

Recommendation for Corrective Action

B.2. We recommend that the Director, DFAS and the Navy Working Capital Fund activities reconcile the inventory related general ledger account balances to supporting records that they maintain.

Department of the Navy Comment

Concur in Principle. As stated in paragraph 020204.B of the DoD FMR, Volume 6, "The DFAS shall establish procedures to ensure that all general ledger balances and other associated financial balances reconciled, at least on a quarterly basis.... with the amounts contained in the supporting records, including original source data." Additionally, paragraphs 020204.A and 020204.B state DoD Component customer participation may be required in the reconciliation process if subsidiary records or source documents are maintained by the DoD Component customer, but DFAS still establishes the reconciliation schedule. Whether DFAS or the DoD Component customer holds required records, it is a DFAS responsibility to initiate reconciliation actions. Therefore, the recommendation should only be addressed to the Director, DFAS. We request the recommendation be written as follows: "We recommend the Director, DFAS, with support from applicable NWCF supply activities as required, reconcile the inventory related general ledger account balances to supporting records."

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report.

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INTERNET DOCUMENT INFORMATION FORM

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Working Capital Fund Financial Statements**

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D. Currently Applicable Classification Level: Unclassified

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