

Audit



Report

PRIOR PERIOD ADJUSTMENT TO REMOVE NATIONAL
DEFENSE PROPERTY, PLANT, AND EQUIPMENT FROM
THE DOD AGENCY-WIDE BALANCE SHEET

Report No. D-2001-011

November 16, 2000

Office of the Inspector General
Department of Defense

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Acronyms

DFAS	Defense Finance and Accounting Service
PP&E	Property, Plant, and Equipment
RSSI	Required Supplementary Stewardship Information
SFFAS	Statement of Federal Financial Accounting Standards



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**

November 16, 2000

**MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE**

**SUBJECT: Audit Report on Prior Period Adjustment to Remove National Defense
Property, Plant, and Equipment From the DoD Agency-Wide Balance Sheet
(Report No. D-2001-011)**

We are providing this report for review and comment. This audit is in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This report is one of two reports on National Defense property, plant, and equipment. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Defense Finance and Accounting Service comments were partially responsive. We request additional comments on Recommendations 2.a., 2.b., 2.c., and 2.d. Although the management comments concurred with Recommendation 2.d., the comments did not indicate the corrective actions that would be taken. We request that the Director, Defense Finance and Accounting Service, provide comments by January 16, 2001.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David F. Vincent at (703) 604-9109 (DSN 664-9109) (dvincent@dodig.osd.mil) or Mr. John A. Richards at (703) 604-9133 (DSN 664-9133) (jrichards@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. D-2001-011

November 16, 2000

(Project No. D2000FH-0080.003)

(formerly Project No. OFH-2109.03)

Prior Period Adjustment to Remove National Defense Property, Plant, and Equipment From the DoD Agency-Wide Balance Sheet

Executive Summary

Introduction. This audit was performed in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This audit report addresses the requirement to remove all dollar amounts representing the new categories of stewardship property, plant, and equipment from the DoD Agency-wide balance sheet by means of a prior period adjustment. The DoD made a prior period adjustment of about \$741 billion and reported about \$698.7 billion of it as removal of National Defense property, plant, and equipment from the balance sheet. This is one of two reports on stewardship reporting in DoD. This report covers the explanation of the prior period adjustment in the DoD Agency-wide financial statement and the explanations in the component statements. A separate audit report covers the Army prior period adjustment.

Objectives. The overall audit objectives were to determine whether the Military Departments were consistently identifying National Defense property, plant, and equipment as defined in the Statement of Federal Financial Accounting Standards No. 11, "Amendments to Accounting for Property, Plant, and Equipment: Definitional Changes," October 1998, and whether the amount of the prior period adjustment that removed National Defense property, plant, and equipment from the balance sheet was correct. Because the prior period adjustments were one-time events, no management control program applies to them. Therefore, a review of management controls for this audit was not applicable.

Results. The DoD Agency-wide financial statements incorrectly stated that \$698.7 billion of the prior period adjustment was made to remove National Defense property, plant, and equipment from the balance sheet. However, only \$635.5 billion of the adjustment was related to National Defense property, plant, and equipment. Therefore, the financial statement footnotes incorrectly overstated by \$63.2 billion the value of National Defense property, plant, and equipment previously reported on the balance sheet before the adjustments. If the dollar values of National Defense property, plant, and equipment had been reported in the required supplementary stewardship information, they would have been incorrect. In addition, future statements showing the dollar value of National Defense property, plant, and equipment will be significantly less than the amount removed. Finally, because DoD information is consolidated into the Government-wide reporting, Government-wide financial statements will continue to be inaccurate until necessary corrections are made and disclosures presented. For details of the audit results, see the Finding section of the report.

Summary of Recommendations. We recommend that the Director, Defense Finance and Accounting Service Indianapolis Center, implement the existing guidance requiring full explanation of all prior period adjustments in the notes to the financial statements. We also recommend that the Director correct the erroneous footnote presentation of the prior period adjustment in future DoD Agency-wide financial statement narratives or footnotes and present, with any appropriate explanations, the correct amounts for National Defense property, plant, and equipment for all applicable components. Finally, we recommend that the Director, Defense Finance and Accounting Service Indianapolis Center, maintain consistency between the DoD Agency-wide financial statements and underlying component statements.

Management Comments. The Defense Finance and Accounting Service concurred with the recommendations to implement existing guidance requiring full explanation of all prior period adjustments and to maintain consistency between the DoD Agency-wide statements and the component statements. However, the Defense Finance and Accounting Service did not concur with disclosing the erroneous statement about the prior period adjustment or with disclosing the correct valuations of National Defense property, plant, and equipment in future financial statements. Additionally, the comments did not indicate the corrective action that would be taken to maintain consistency between the DoD Agency-wide statements and the component statements. The Defense Finance and Accounting Service considered the additional disclosures inappropriate and unnecessary. See the Finding section of the report for a discussion of the management comments and the Management Comments section for the complete text.

Audit Response. Management comments are partially responsive. The intent of our recommendations for future financial statements was to ensure that financial statements, footnotes, and other financial information clearly document the value of National Defense Property, Plant, and Equipment removed from the financial statements. The Defense Finance and Accounting Service did not address the fact that the overstatement of this value by at least \$63.2 billion could be repeated if the Federal Accounting Standards Advisory Board reinstates National Defense Property, Plant, and Equipment on the DoD financial statements. Additionally, although the management comments concur with the recommendation to maintain consistency between DoD Agency-wide statements and component statements, they do not identify the action to be taken. We request that the Director, Defense Finance and Accounting Service, provide comments on the final report by January 16, 2001.

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Background

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 and prescribes the responsibilities of management for the financial statements, internal controls, and compliance with laws and regulations. This report addresses the prior period adjustment to the net position of DoD. The FY 1998 DoD Agency-wide financial statements reported that \$698.7 billion of the \$741 billion prior period adjustment was for removal of National Defense property, plant, and equipment (PP&E) from the balance sheet. We disclaimed an opinion on the FYs 1998 and 1999 DoD Agency-wide financial statements. The disclaimers occurred for a number of reasons, in part because of deficiencies in internal controls and accounting systems related to general property, plant, and equipment; inventory; environmental liabilities; military retirement health benefits liability; and material lines within the Statement of Budgetary Resources.

Property, Plant, and Equipment Reporting Requirements. Statement of Federal Financial Accounting Standards (SFFAS) No. 6, "Accounting for Property, Plant, and Equipment," November 1995, is the first SFFAS to address accounting and reporting requirements for PP&E. It establishes two categories of Federal PP&E: general PP&E and stewardship PP&E.

General PP&E. SFFAS No. 6 defines general PP&E as any property, plant, and equipment used in providing goods or services. It also prescribes accounting and reporting requirements for general PP&E. General PP&E is recorded at cost on the balance sheet and, except for land, the cost is depreciated over the estimated useful life of the assets.

Stewardship PP&E. SFFAS No. 6 defines three categories of stewardship PP&E: National Defense PP&E (formerly Federal mission PP&E) is one of the three categories. See Appendix B for definitions of the three categories. In most cases, the dollar value of stewardship PP&E is not included in the balance sheet. Additional stewardship guidance is provided in SFFAS No. 8 and SFFAS No. 11.

SFFAS No. 8, "Supplementary Stewardship Reporting," June 1996, added two broad areas of stewardship reporting to stewardship PP&E: stewardship investments and stewardship responsibilities. SFFAS No. 8 also established reporting requirements for all three stewardship categories. All stewardship reporting is in the Required Supplementary Stewardship Information (RSSI) section of the financial statements. Both SFFAS No. 6 and SFFAS No. 8 became effective for fiscal periods beginning after September 30, 1997.

SFFAS No. 11, "Amendments to Accounting for Property, Plant, and Equipment: Definitional Changes," October 1998, and Statement of Recommended Accounting Standards No. 16, "Amendments to Accounting for

Property, Plant, and Equipment: Measurement and Reporting for Multi-Use Heritage Assets," July 1999, would both affect PP&E reporting in the future, but were not in effect at the time of the FY 1998 prior period adjustment.

Prior Period Adjustments of Property, Plant, and Equipment. For each category of stewardship PP&E, SFFAS No. 6 requires that amounts previously recognized as assets be removed from the balance sheet. Acquisition costs of the stewardship PP&E, minus the associated accumulated depreciation, must be subtracted from the amounts that represented assets in the PP&E section of the balance sheet. The net amounts removed were to be offset with a reduction to the net position of the entity and reported as a prior period adjustment. The amount of the prior period adjustment associated with removal of the stewardship PP&E was to be disclosed in a footnote.

Because general PP&E would continue to be reported on the balance sheet, no prior period adjustment to remove it was required. However, SFFAS No. 6 requires that both the cost and accumulated depreciation to date of any unrecognized general PP&E, or the net of the two figures, be recorded in the FY 1998 implementation year, with the net amount recognized as a prior period adjustment in the statement of changes in net position. If the cost of the assets had not previously been recognized, such adjustments would be additions to, rather than deletions from, the balance sheet.

Reporting of National Defense PP&E. DoD reported quantities of National Defense PP&E when it should have reported the dollar value as prescribed by SFFAS No. 8. We discussed that condition in Inspector General, DoD, Audit Report No. 99-210, "Stewardship Reporting in the DoD Agency-Wide Financial Statements for FY 1998," July 9, 1999, but we acknowledged that the guidance was being reconsidered at that time.

The guidance issue was still unresolved at the time of this audit. The Federal Accounting Standards Advisory Board (the Board) was trying to decide the most appropriate way to report National Defense PP&E. The discussion included an extensive study of the intricacies of reporting values of National Defense PP&E, indicating that reporting of values is likely to remain a requirement. Although the reporting of values would not necessarily mean returning the National Defense PP&E values to the balance sheet, the possibility remains.

Proposed Future Reporting of the Elements of RSSI. The Board was proposing to eliminate the designation "RSSI." Each element of what had been reported as RSSI would become either basic information, equivalent in importance to the principal financial statements, or the less audited required supplementary information. As of June 9, 2000, the Board had not yet decided into which category National Defense PP&E should go, but had already decided that heritage assets and stewardship land should be basic information. Any actual changes to the SFFAS have to go through a public comment process. The target date for implementation of any of those changes is FY 2003.

RSSI Audit Requirement. The Office of Management and Budget bulletin, "Audit Requirements for Federal Financial Statements," establishes the minimum

requirements for audits of Federal financial statements. As of September 30, 1999, with RSSI still a reporting category, the Office of Management and Budget removed the requirement to audit RSSI for the purpose of rendering an opinion on it, as would be required for basic information. Instead, auditors were to apply the less extensive procedures appropriate for reviewing required supplementary information. As a result of the Office of Management and Budget actions, we were not required to render an opinion on RSSI.

Objectives

Our overall audit objectives were to determine whether the Military Departments were consistently identifying National Defense property, plant, and equipment as defined in SFFAS No. 11, "Amendments to Accounting for Property, Plant, and Equipment: Definitional Changes," October 1998, and to determine whether the amount of the prior period adjustment removing National Defense PP&E from the balance sheet was correct. Because the prior period adjustments were one-time events, no management control program applies to them. Therefore, a review of management controls for this audit was not applicable. This report covers inconsistencies between the explanations of the prior period adjustment between the DoD Agency-wide financial statements and the component statements. We discussed the Army prior period adjustment in Inspector General, DoD, Report No. D-2000--165, "The Prior Period Adjustment to Remove National Defense Property, Plant, and Equipment From the Army General Fund Balance Sheet," July 21, 2000. Appendix A discusses the scope, methodology, and prior audit coverage.

DoD Agency-Wide Prior Period Adjustment for Removal of National Defense Property, Plant, and Equipment

The Defense Finance and Accounting Service (DFAS) Indianapolis Center overstated the value of National Defense property, plant, and equipment (PP&E) removed from the DoD Agency-wide financial statements balance sheet, \$635.5 billion, by \$63.2 billion. In addition, the explanations for the prior period adjustment were inadequate. The overstatement occurred because adjustments were included that were not related to National Defense PP&E. Furthermore, the DoD consolidated total (\$698.7 billion) exceeded the value (\$676.6 billion) of the sum from the component statements, and the narratives did not identify the dollar values associated with each adjustment. As a result, the statements incorrectly associated the value of \$698.7 billion with the National Defense PP&E quantities reported in the RSSI section. Additionally, if DoD is later required to report National Defense PP&E by dollar value instead of by quantity, the amounts reported will not be consistent with the \$698.7 billion.

Breakdown of the DoD Agency-Wide Prior Period Adjustment

Table 1 shows the breakdown by component statement and by type of adjustment.

Table 1. Breakdown of the Prior Period Adjustment (dollars in millions)

<u>Reporting</u>	<u>Change in Accounting Standards</u>	<u>Error Correction</u>	<u>Other</u>	<u>Consolidating Statement Total</u>
Army General Fund (GF)	\$144,536.432	\$ 0	\$ 0	\$144,536.432
Navy GF	340,685.736	-1,168.556	11.240	339,528.420
Air Force GF	208,516.895	32,206.877	0	240,723.772
Army Working Capital Fund (WCF)	0	-228.093	0	-228.093
Navy WCF	0	-55.694	1,020.920	965.226
Air Force WCF	0	0	3,255.603	3,255.603
Defense Logistics Agency WCF	-107.595	-159.839	0	-267.434
DFAS WCF*	0	-107.837	20.811	-87.026
Military Retirement Trust Fund	0	0	0	0
Army Corps of Engineers – Civil Works	0	1,854.140	0	1,854.140
Other Defense Organizations GF	5,034.346	0	5,621.341	10,655.687
Other Defense Organizations WCF	0	34.739	24.934	59.673
Total	\$698,665.814	\$32,375.737	\$9,954.849	\$740,996.400

*The DFAS Working Capital Fund information was not entirely clear. The breakdown shown in this table was the interpretation of the preparer of the DoD Agency-wide financial statements. In our opinion, the entire amount was represented as "Error Correction" in the DFAS Working Capital Fund statements.

Prior Period Adjustments on the Component Statements

Based on the component statements, DFAS Indianapolis Center should have reported no more than \$676.6 billion of the \$698.7 billion "Change in Accounting Standards" as removal of National Defense PP&E. The \$676.6 billion was overstated, because the actual value of the National Defense PP&E was closer to \$635.5 billion. As shown in Table 1, the Army, Navy, Air Force, and Other Defense Organizations General Funds and the Defense Logistics Agency Working Capital Fund make up the \$698.7 billion "Change in Accounting Standards." Table 2 shows how the amounts appeared in the component statements, and how they should have appeared. A section on each component follows Table 2.

**Table 2. Dollar Value of National Defense PP&E
Removed From Balance Sheet
(dollars in millions)**

	Per DoD Agency- Wide Statements	Per Component Statements	Estimated Value Per Audit
Army General Fund	\$144,536	\$144,536	\$106,965
Navy General Fund	340,686	323,617	338,307
Air Force General Fund	208,517	208,434	189,802
Defense Logistics Agency Working Capital Fund (108)		0	0
Other Defense Organizations General Fund	5,034	0	401
Total	\$698,665	\$676,587	\$635,475

Army General Fund. The DoD Agency-wide statement explanation was consistent with the Army General Fund statement. The Army General Fund statement actually did say that the entire \$144.5 billion "Change in Accounting Standards," which was also the entire adjustment, was for removal of National Defense PP&E. However, about \$29.9 billion of the adjustment had nothing to do with National Defense PP&E. We do not have a figure for National Defense PP&E as of September 30, 1997, the date to which the adjustment should have applied, but the logistics reported figure for September 30, 1998, was about \$107 billion. DFAS Indianapolis Center did not use the \$107 billion figure at all in calculating the prior period adjustment.

Navy General Fund. The DoD Agency-wide statements should not have treated the Note 18 prior period adjustment total in the Navy General Fund as National Defense PP&E. Within the note, the part for "Change in Accounting Standards" had a total of \$340.7 billion. The total included \$17.1 billion for adjustments to general PP&E, about \$277 billion for military equipment, \$42.1 billion for war reserves, and \$4.5 billion for progress payments. The narrative for Note 18 does not specifically provide the value of National Defense PP&E.

Analysis of the Navy General Fund financial statements showed that the statements were combining the military equipment, war reserves, and progress payment amounts, totaling \$323.6 billion--everything except the \$17.1 billion for

general PP&E--as the National Defense PP&E value. However, based on supporting documents, our review calculated the value for National Defense PP&E at approximately \$338.3 billion.

Air Force General Fund. The Air Force General Fund statements, while not entirely clear, vaguely implied that \$208.5 billion in "Changes in Accounting Standards" was for removal of National Defense PP&E. However, from the descriptions of categories comprising the \$208.5 billion, only categories totaling \$163 billion were clearly National Defense PP&E categories. Of the remaining "Changes in Accounting Standards" categories, the category for land, \$83.2 million, was clearly not for the removal of National Defense PP&E. Therefore, the DoD Agency-wide statements should have reduced the amount shown by at least \$83.2 million, to about \$208.4 billion. Table 2 uses this value as the maximum amount that reasonably could be assumed to be National Defense PP&E based on the Air Force General Fund statements.

Additional analyses indicated that the category of buildings, \$532 million, was for multi-use heritage assets and should not have been included as a National Defense PP&E adjustment, or as any prior period adjustment. Finally, the category of equipment with contractors, \$18.1 billion, was not supported as a National Defense PP&E adjustment, or as any prior period adjustment. Eliminating the adjustments for land, buildings, and equipment with contractors from the National Defense PP&E valuation yields an estimate of \$189.8 billion in prior period adjustments made as a result of changes in accounting standards for removal of National Defense PP&E. Therefore, the value for National Defense PP&E was overstated by \$18.7 billion, because it reflected a value of \$208.5 billion instead of \$189.8 billion.

Defense Logistics Agency Working Capital Fund. The Defense Logistics Agency Working Capital Fund statements clearly identified the entire -\$0.1 billion prior period adjustment as being for reasons other than the removal of National Defense PP&E. Most of it was to adjust for a change in the method of recognition of gains and losses on inventory revaluations, and about \$73,000 was for a change in the method of accounting for collection of refunds. In addition, the statements specifically stated that the Defense Logistics Agency did not have any National Defense PP&E. Accordingly, the DoD Agency-wide statements should not have identified any of the amount as removal of National Defense PP&E.

Other Defense Organizations General Fund. The unpublished FY 1998 Other Defense Organizations General Fund statements gave no explanation for the \$5.03 billion "Change in Accounting Standards" portion of its prior period adjustment. Only the U.S. Special Operations Command, of the 21 Other Defense Organizations that were consolidated, had National Defense PP&E. As of September 30, 1997, the agency owned major end items categorized as National Defense PP&E, which cost approximately \$401 million. Therefore, \$401 million of the \$5.03 billion prior period adjustment should have been the value in the change in accounting standards needed to remove National Defense PP&E from the balance sheet. The remaining \$4.63 billion should have been reported as "Errors and Omission in Prior Year Accounting Reports."

Explanation of the DoD Agency-Wide Prior Period Adjustment

The DFAS Indianapolis Center prepares the DoD Agency-wide financial statements. The total prior period adjustment on the DoD Agency-wide financial statements was approximately \$741 billion. The notes to the financial statements did not completely explain the adjustment. Table 3 shows the exact wording of the applicable footnote, although not the exact format.

Table 3. Exact Wording of the DoD Agency-Wide Footnote on the Prior Period Adjustment
(dollars in thousands)

*Prior Period Adjustments	
Changes in Accounting Standards	\$698,665,814
Errors and Omission in Prior Year Accounting Reports	32,375,737
Other	9,954,849
Total	\$740,996,400

***Other Information:** Prior period adjustments were used to remove the value of October 1997, PP&E designated by federal accounting standards as National Defense PP&E for the balance sheet. Those items are reported in the Stewardship Statement. Current year acquisitions of National Defense PP&E are expensed in accordance with the standards.

*Air Force made a \$31.4 billion adjustment to record accumulated depreciation for September 1997 depreciable assets. Depreciation, though required, had not been previously reported in the financial statements."

The explanation does not cover the entire adjustment and is ambiguous as to what is covered. The first paragraph does not specifically say whether it applies to the "Changes in Accounting Standards" line and talks about removal of National Defense PP&E from the balance sheet without giving any associated dollar amount. Based on that information, the possible conclusions are that the \$698.7 billion all applied to removal of National Defense PP&E, or that the \$698.7 billion was not fully explained. The only part of the entire \$741 billion with an amount specified is the \$31.4 billion Air Force adjustment to record accumulated depreciation for September 1997 depreciable assets (general PP&E). Because of the placement in the second paragraph, it appears that the \$31.4 billion is part of the \$32.4 billion "Errors and Omission in Prior Year Accounting Reports," but it could apply to "Changes in Accounting Standards." The footnote gives no further information about any unexplained amounts of "Changes in Accounting Standards" or "Errors and Omission in Prior Year Accounting Reports." The \$9.9 billion "Other" line is completely unexplained.

Effects of Representing the Entire Adjustment as National Defense PP&E

The lack of clarity in the note explaining the prior period adjustment was not in compliance with the DoD guidance for financial statement preparation. According to DoD Regulation 7000.14-R, volume 6B, "Form and Content of Department of Defense Audited Financial Statements" (the DoD Form and Content), entities are to disclose the nature and amount of significant prior period adjustments. They are to identify specifically any amounts with a value greater than \$100 million.

The effects of representing the entire adjustment as National Defense PP&E go beyond properly disclosing the portions that removed stewardship PP&E as required by SFFAS No. 6 and the DoD Form and Content. The financial statement presented an overstated value for National Defense PP&E of \$698.7 billion as of September 30, 1997. As a result, the statements would also be associating the \$698.7 billion with the National Defense PP&E quantities reported in the financial statements' RSSI, adjusted for any current year additions and deletions.

Statement of Federal Financial Accounting Concepts No. 1, "Objectives of Federal Financial Reporting," September 2, 1993 (Concept 1), states that information in financial reporting should represent what it purports to represent. Statement of Federal Financial Accounting Concepts No. 2, "Entity and Display," April 20, 1995, states that accompanying footnotes to financial statements are an integral part of the statements and are needed to make the statements more informative and not misleading. The footnote was misleading because the \$698.7 billion prior period adjustment represented significantly more than the removal of National Defense PP&E from the balance sheet. Concept 1 also states that no material information should be omitted. The DoD Agency-wide statements did not disclose the fact that according to the component statements, only \$676.6 billion of the \$698.7 billion was for removal of National Defense PP&E.

Finally, Concept 1 requires financial reports to be consistent over time. The DoD should report National Defense PP&E by dollar value, but instead DoD reported it by quantity. If DoD later reports National Defense PP&E by dollar value, the amount reported will be significantly less than the \$698.7 billion. The significance of the inconsistency could increase if the Board makes the dollar value basic information rather than required supplementary information, and it would become significantly more relevant if the dollar value were returned to the balance sheet.

In addition to the effects on DoD financial statements, because DoD information is consolidated into the Government-wide reporting, Government-wide financial statements will continue to be inaccurate and unreliable until necessary corrections are made and disclosures presented.

Recommendations, Management Comments, and Audit Response

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

1. Implement DoD Regulation 7000.14-R, volume 6B, "Form and Content of the Department of Defense Audited Financial Statements" guidance that requires entities to fully explain all prior period adjustments exceeding \$100 million in the applicable footnotes.

Management Comments. DFAS concurred and stated that it had made every effort to fully disclose material conditions. DFAS stated that it would work with the supporting accounting and logistics offices to improve the area during FY 2000. DFAS expects completion by January 31, 2001.

2. In FY 2000 and beyond DoD financial statement footnotes and narratives:

a. Disclose the actual valuation of National Defense property, plant, and equipment removed from the statements.

b. State the value of the National Defense property, plant, and equipment reported for FY 1998, with any necessary disclaimers on the accuracy of the amount.

c. Restate what the adjustment actually represented.

Management Comments. DFAS did not concur and stated that addressing the FY 1998 prior period adjustment narrative misstatement was not appropriate or necessary. DFAS added that DoD Regulation 7000.14-R, volume 6B, "Form and Content of the Department of Defense Audited Financial Statements" for FY 1998 did not require disclosure of the value of the National Defense PP&E removed from the balance sheet. DFAS also stated that addressing the FY 1998 value of the National Defense PP&E prior period adjustment in the FY 2000 and future financial statements was inappropriate and unnecessary.

Audit Response. The DFAS comments are not responsive to the recommendations. The intent of our recommendations was to ensure that financial statements, footnotes, and other financial information clearly document the value of National Defense Property, Plant, and Equipment that was removed from the financial statements. As evidenced by the audit results, the \$698.7 billion included other items that were not related to National Defense Property, Plant, and Equipment. Our recommendations to disclose the actual valuation of the National Defense Property, Plant, and Equipment in the footnotes were to ensure that the appropriate value for these assets would be presented in the financial statements.

The Federal Accounting Standards Advisory Board is currently deliberating whether or not to reinstate National Defense Property, Plant, and Equipment on the DoD financial statements. The \$698.7 billion in National Defense Property, Plant, and Equipment removed from the balance sheet in FY 1998 was overvalued by at least \$63.2 billion. In

the event that the Federal Accounting Standards Advisory Board does require the reinstatement of National Defense Property, Plant, and Equipment on the DoD financial statements, the amount that would be reported is the erroneous \$698.7 billion. In that case, National Defense Property, Plant, and Equipment would continue to be overstated by at least \$63.2 billion.

We believe that in order to prevent this from occurring, action should be taken to disclose for FY 2000 and beyond the correct valuation of the items that were removed from the financial statements. Accordingly, we request that the DFAS reconsider its position and provide specific actions to be taken to implement the recommendations or propose alternative actions that would ensure that the DoD accurately and consistently reports the value of National Defense Property, Plant, and Equipment now and in the future. An example of an alternative action would be a requirement for the Military Departments to recalculate the value of National Defense Property, Plant, and Equipment to ensure that only those items are accounted for in the valuation. The results of this recalculation should be retained in the event that National Defense Property, Plant, and Equipment is reinstated on the DoD financial statements.

d. Maintain consistency between the DoD Agency-wide financial statements and underlying component statements.

Management Comments. DFAS concurred and gave an estimated completion date of January 31, 2001. However, DFAS did not specify what corrective action it would take and stated that in the preparation of the FY 1998 prior period adjustment, it maintained consistency between the DoD Agency-wide statements and the component statements.

Audit Response. The comments are not responsive in that they do not specify what corrective action management plans to take. Additionally, they do not explain how the DoD Agency-wide statements could be consistent with component statements when the Agency-wide statements represented the removal of National Defense PP&E as \$698.7 billion, and the component statements represented it as \$676.6 billion. We request that DFAS provide additional comments on this recommendation.

Appendix A. Audit Process

Scope

Work Performed. We reviewed the DoD Agency-wide financial statements and the component statements, including the unpublished ODO General Fund statements, regarding the prior period adjustments. We also interviewed personnel at the DFAS Indianapolis Center and discussed the basic methodology that they used in preparing the DoD Agency-wide financial statements. We were not required to and did not render an opinion on the RSSI statements.

Limitations to Scope. Although we obtained reasonable estimates of the value of National Defense PP&E held by the Military Departments and the ODO General Fund, we were unable to determine exactly what the amounts of the adjustments should have been. The correct amounts would have been the amounts on the applicable balance sheets as of September 30, 1997, that represented the various types of stewardship PP&E. The components had not calculated those amounts because RSSI was not a requirement in FY 1997. The DoD Agency-wide FY 1997 balance sheet had a value for military equipment, but the value did not correspond to National Defense PP&E for FY 1998.

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 goal, subordinate performance goal, and performance measure:

- **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 2.5.2:** Achieve unqualified opinions on financial statements. (01-DoD-2.5.2)

General Accounting Office High-Risk Areas. 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

Use of Computer-Processed Data. We did not use computer-processed data for this report.

Audit Type, Dates, and Standards. We conducted this financial-related audit from June 1999 through July 2000 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

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

Prior Coverage

Inspector General, DoD, Report No. D-2000-165, "The Prior Period Adjustment to Remove National Defense Property, Plant, and Equipment from the Army General Fund Balance Sheet," July 21, 2000

Appendix B. Categories and Reporting Requirements for Stewardship Property, Plant, and Equipment

The three categories of stewardship PP&E and the reporting requirements for them are as follows.

National Defense PP&E (Originally Federal Mission PP&E). The National Defense PP&E category consists of weapon systems and support PP&E owned by DoD or its component entities for use in the performance of military missions and vessels held in a preservation status by the Maritime Administration's National Defense Reserve Fleet. National Defense PP&E is typically held for use in the event of war or other emergency. Additional characteristics of National Defense PP&E are an indeterminate or unpredictable useful life and a high risk of being destroyed during use or becoming obsolete prematurely. For these reasons, the usual depreciation of roughly equal portions of the cost over the estimated useful life, starting at the time of acquisition, does not reflect the way the assets are actually used. Starting in FY 1998, costs of acquisition and improvement of National Defense PP&E were to be recognized as expenses in the year incurred.

SFFAS No. 8 requires the reporting of National Defense PP&E as RSSI in dollars at acquisition cost. That requirement was in effect at the time of the audit. Therefore, the cost of National Defense PP&E removed from the balance sheet, adjusted for the intervening years' activity, should be reconcilable with cost reported as RSSI.

Heritage Assets. Heritage assets are PP&E unique for historical or natural significance; cultural, educational, or artistic importance; or significant architectural characteristics. Heritage assets are divided into collection-type heritage assets, such as items in a museum, and noncollection-type assets, such as historic buildings. Except as noted below, the expectation is that heritage assets will be preserved rather than used and will be kept for an indefinite period. Additionally, it may be impossible to determine any reasonable value. Unlike National Defense PP&E, reporting of heritage assets in RSSI is in physical units, not dollars. New acquisition and improvement costs are to be expensed as incurred.

Multi-use heritage assets, generally noncollection type, consist of PP&E items that have the properties of heritage assets and are also used in Government operations. Statement of Recommended Accounting Standards No. 16 (in Congress for review before issuance as SFFAS No. 16), "Amendments to Accounting for Property, Plant, and Equipment - Measurement and Reporting for Multi-Use Heritage Assets," July 1999, states that the assets should remain on entity balance sheets, in dollars, as general PP&E. They are also to be reported on the heritage asset statement in physical units. New acquisition and improvement costs are to be capitalized and depreciated rather than expensed. Therefore, the adjustment to remove heritage assets from the balance sheet would not include

multi-use heritage assets. Although the effective date for SFFAS No. 16 is FY 2000, DoD has already taken the prescribed approach to accounting for multi-use heritage assets.

Stewardship Land. Stewardship land is land owned by the Federal Government and not acquired for or in connection with general PP&E. Examples in SFFAS No. 6 are forests, parks, and land used for wildlife and grazing. As with heritage assets, reporting is in physical units such as acres, not dollars. Further interpretations of SFFAS No. 6 extend the definition to donated land and land allocated from the public domain, for which no acquisition cost is available, and for which a determination of the value may be difficult. That further interpretation can include land used operationally; in fact, a large number of active military bases are located on former public domain land. The cost of land, including general PP&E land, is never depreciated. Any new costs to acquire or improve stewardship land are expensed as incurred.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Under Secretary of Defense (Comptroller/Chief Financial Officer)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

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

Unified Commands

Commander in Chief, U.S. Special Operations Command

Other Defense Organizations

Director, Defense Finance and Accounting Service
Director, Defense Finance and Accounting Service Indianapolis Center
Director, Defense Logistics Agency

Non-Defense Federal Organizations

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Members

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

Defense Finance and Accounting Service Comments



DFAS-HQ/ASF

DEFENSE FINANCE AND ACCOUNTING SERVICE


1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291

SEP 14 2000

MEMORANDUM FOR DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE,
OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF
DEFENSE

SUBJECT: Audit Report on Prior Period Adjustment to Remove National Defense Property,
Plant, and Equipment From the DoD Agency-Wide Balance Sheet (Project
No. D2000FH-0080.003) (formerly Project No. 0FH-2109.03)

Our response to the subject audit is attached. The point of contact is Mr. Wayne Ebaugh,
(703) 607-2857 or DSN 327-2857.


Edward A. Harris
Director for Accounting

Attachment:
As stated

cc:
DFAS-HQ/DI
DFAS-IN/P

DFAS Comments DoDIG Audit Report Prior Period Adjustment to Remove National Defense Property, Plant, and Equipment From the DoD Agency-Wide Balance Sheet (Project No. D2000FH-0080.003) (formerly Project No. 0FH-2109.03)

Responses to Recommendations

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

1. Implement DoD Regulation 7000.14-R, volume 6B, "Form and Content of the Department of Defense Audited Financial Statements" guidance that requires entities to fully explain all prior period adjustments exceeding \$100 million in the applicable footnotes.

Management Comments: Concur. The Defense Finance and Accounting Service (DFAS) Center for Sustaining Forces - Indianapolis has made every effort to fully disclose all material conditions that either require disclosure as prescribed by regulation or materially impact financial statements. During fiscal year (FY) 2000, the Center for Sustaining Forces - Indianapolis will actively participate with the supporting accounting and logistics activities to improve this critical area.

Estimated Completion Date: January 31, 2001.

2. In FY 2000 and beyond DoD financial statement footnotes and narratives:

a. Disclose the actual valuation of National Defense property, plant, and equipment removed from the statements.

Management Comments: Nonconcur. In accordance with DoD Regulation 7000.14-R, Volume 6B, "Form and Content of the Department of Defense Audited Financial Statements" 1998 guidance, disclosure of the value of National Defense property, plant, and equipment (PP&E) that was removed from the DoD Agency-wide Balance Sheet for FY 1998 was not required. However, the Center for Sustaining Forces - Indianapolis' narrative description of the prior period adjustment was incorrect. Regardless, addressing the FY 1998 National Defense PP&E prior period adjustment narrative misstatement in FY 2000 and other future financial statements is inappropriate and unnecessary.

b. State the value of the National Defense property, plant, and equipment reported for FY 1998, with any necessary disclaimers on the accuracy of the amount.

Management Comments: Nonconcur. Addressing the FY 1998 value of the National Defense PP&E prior period adjustment, with any disclaimer, in FY 2000 and other future financial statements is inappropriate and unnecessary.

c. Restate what the adjustment actually represented.

Management Comments: Nonconcur. Addressing the FY 1998 value of the National Defense PP&E prior period adjustment, with any disclaimer, in FY 2000 and other future financial statements is inappropriate and unnecessary. The adjustment to remove National Defense PP&E from the balance sheet was done in the FY 1998 statements and has no impact on financial statements for future years. Therefore, no additional disclosure is required by the Department of the Army or by DFAS.

d. Maintain consistency between the DoD Agency-wide financial statements and underlying component statements.

Management Comments: Concur. The DFAS Center for Sustaining Forces - Indianapolis maintained consistency between the DoD Agency-wide and Component statements in preparation of the 1998 prior period adjustment.

Completion Date: January 31, 2000.

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General who contributed to this report are listed below.

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Inspector General, Department of Defense
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Arlington, VA 22202-2884

D. Currently Applicable Classification Level: Unclassified

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